بسم الله الرحمن الرحيم

IN THE NAME OF ALLAH
THE MOST GRACIOUS THE MOST MERCIFUL

ACCOUNTING

I.COM & B.COM PART-I

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To Our Parents

PREFACE

In today's business sphere, accountancy has become an integral part of the mechanism by which we reconcile our ideas with the changing environment. But over the years it has licked the technical intricacies while apparently giving less satisfaction to our students. Although a goodly number of books were authored on the subject, yet none of them could ever touch the intellectual grit of our knowledge-seekers. In view of this sorry state of affairs, we took the herculean task of ball-pointing a book on accounting which we, hope, would truly illumine the fate of its user.

While browsing through this unique book you will soon realise the fact that we have not simply banked on just casual digging of the material in a slip-shod manner, rather a possible attempt has been made to change the students ambiguous world of accounting into elements of simplicity and clarity. A distinguishing feature of the book becomes more distinct when it is gauged in terms of its exhaustive approach towards the vital subject of accounting, the utility of which cannot be denied, in any way, in our dos and don'ts of business. For this very purpose, we have left no source untapped and no corner unexplored to blend this piece of work with a glare of novelty and glow of durability. Besides, the book gets an extra mark for its genuine flavouring of update stuff with a dash of feeling to flush away stereo-typed and expired material; the material that has been eclipsed even in British System due to the lack of flair of newness as is totally incompatible with the modern trends, and is not glued to the latest research work. Moreover, the book does not simply stand for traditional 'Number Crunch' in accounting, it is distinctively a brand new product of deep reflection and a package of painstaking efforts; it brushes the old and odd methodology aside and seeks to express the underneath meaning of accounting through coherence and consistency in a modern style; it bears the unmistakable stamp of wide variety of illustrative material to backup the text.

In the preface to the first volume of this book, we firmly believe that it would prove a boon to our prospective students. Also, it has been prepared, especially, for our business-elites who employ accounting for business know-how in their tension-propelled jobs, and for those who intend to grasp it without particular guidance and supervision.

Acknowledgements are always in order as part of author's preface and we must begin by thanking Prof. Azhar Ikram Ahmad, Dean of Commerce, Punjab University, and Prof. Nazir Ahmad of Hailey College of Commerce, whose helpful and knowledgeable advice on matters concerning the update information, was indeed invaluable to us. Our very special thanks to our academic colleague, Prof. Shakil Amjad who read the manuscript microscopically and checked it very skillfully.

Authors

Preface
To the 3rd Edition

It is a matter of immense pleasure and great privilige for us to present the 3rd Revised Edition of "ACCOUNTING" an intuitive approach. This revision has given us an opportunity to rewrite, to reorganise, to condense, to expand and to add new study material. A number of problems and illustrations have been included and a few unnecessary and extra illustrations have been excluded to make the book more condensed and comprehensive.

We are thankful to all those readers, especially teachers to have taken pains to convey to us through feed back service or otherwise, their suggestions and comments which have helps us a lot in improving the quality of the scope. Further suggestions from readers are welcome

Authors

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CHAPTER - 1

INTRODUCTION

INTRODUCTION

NEED AND IMPORTANCE OF ACCOUNTING:

We live in a world where people need things from the day they are born to the day that they die. Some of these 'needs' are physical needs, a need for goods of various sorts, food, clothing, shelter, and so on. Some of them are emotional 'wants', a need for education, entertainment, or recreation. In satisfying such needs businessmen perform useful services to their fellow humans. In return they expect to earn a reasonable reward for their efforts in the form of profits.

"Cut your coat according to your cloth" -- so goes the saying. Even a king becomes a pauper, if he fails to exercise economy in his expenditures. In other words, every individual will have to plan his expenditure according to his income. Obviously the question arises -- why is this planning necessary? The need for such planning arises as our wants or desires or needs for goods and services are unlimited, while the means, i.e. the income with which to buy such goods and services are limited. Where, however, goods and services are available free of cost, i.e. gifts of nature, such as air, water (not in cities) etc., there is no question of economy. But the necessity of economy is undeniable, where goods or services are not available free of cost and their supply is limited.

A proper and fair planning of expenditures helps us to ensure proper use of our income. Of course, it is true that the quantity of goods or money cannot be increased by making a proper planning. But certainly we can ensure most economic use of goods or money at our disposal.

Most of us do maintain some kind of a written record of our income and expenditure. The idea behind maintaining such record is to know the correct position regarding income and expenditure. The need for keeping a record of income and expenditure in a clear and systematic manner has given rise to the subject of 'book-keeping'.

Some individuals do not recognise the necessity of keeping accounts of their day-to-day expenditures, since they spend their own income and are not required to account for it to anybody else. But such an idea is wrong. A family, however, small it may be, must exercise proper control over its expenditures so as to ensure future security. A family has two-fold responsibilities -- one is that of ensuring all (round welfare of the family and the other is the social responsibility. Needless to say, money is the most essential pre-request for ensuring peace and happiness of a family, which each and every member desires. The quantum of money must be adequate in relation to the needs. But mere adequacy of money will not do; one has to take care of its proper utilization. For this it would be necessary to exercise economy and maintain proper books of account. On the other hand each and every family must save a portion of its income for future contingencies. It is possible to increase the amount of saving through proper management and effective control of the family expenses. Through such saving the family helps materialising the economic planning of the country.

It is all the more necessary for an organisation or a concern to keep proper accounts. At the end of the year the true result of the economic activities of a concern must be made available otherwise it will not be possible to run the concern. In case of a business concern the profit or loss at the end of a year must be ascertained, because, the amount of profit must be adequate in relation to that of investment made in the business. If it is not so or if there is a loss, it is an indication of some defects existing somewhere in the management of the business. All such defects need to be detected and analysed and appropriate measures taken for their rectification. But it is only possible, if proper books of accounts are maintained in the business concern. So, ***the importance of book-keeping to a business is the same as that of fresh air to a man to exist. Without book-keeping records a business would meet death, though not instantly, but in a short time.***

Moreover, if proper books of accounts are not kept in a business, the amount of profit cannot be ascertained and it will not be possible to distribute the profit among the owners of the business. The income tax dues to the Government cannot also be paid. In the absence of books of accounts misuse or defalcation of money will remain undetected. The owner and other parties interested will not be able to have any information about the condition of the business. For the same reason in the case of non-trading concerns like, schools, clubs, colleges, universities, hospitals etc. the need for accounting is universally recognised.

Thus we see that the necessity of keeping accounts is not only confined to business concerns but it is also useful for all classes and grades of people and organisations.

ACCOUNTING: A BUSINESS LANGUAGE

Accounting is a language, a system that communicates information. It is often referred to as the language of the business, although it is just as important in the operation of government agencies, clubs, colleges and other kinds of organisations.

You probably have some idea already of what the term accounting means. It is frequently used in every day conversation to mean "answering for responsibility." Managers of business concerns are answerable to owners, creditors, labour unions and Government agencies etc. Managers of government units are answerable to chief executives, boards, taxpayers and others. In fact, accounting was developed by people, who were seeking better ways to gather and report useful information about organisations.

Some type of orderly system is needed to account for an organisation of any size and complexity. An accounting system is used to collect, process and report needed data about a business, government unit, or other type of association. Information is usually collected, processed and reported in financial terns, which simply means that 'money' is the basis of measurement.

Many authors have defined the term "Accounting" in different ways. There is difference of opinion among the authors as to its precise definition as the term accounting is so broad that it is difficult to give a precise definition. However, several possible definitions are given below:

1. "The act of collecting, processing, reporting, analyzing, interpreting and projecting financial information".
2. "The system of providing quantified information about an organisation to people who need such information."
3. "The process of identifying, measuring, and communicating economic information to permit informed judgments and decisions by users of the information."

Of all the definitions available the most accepted is the one given by the American Institute of Certified Public Accountants Committee on Terminology According to it.

"Accounting is the art of recording, classifying and summarising in a significant manner and in terms of money, transactions and events, which are, in part at least, of a financial character, and interpreting the result thereof". An analysis of the definition will enable us to have a thorough idea of the functions of accounting. The salient features of the definition are:

1. CONNECTED WITH A MONETARY EVENT OR TRANSACTION:

Accounting must be in relation to a monetary event or transaction and the event or transaction must be measurable in terms of money. In other words, no accounting is possible for an event or transaction which is not measurable in terms of money, e.g. passing an examination, delivering lecture in a meeting. winning a game etc. These are events no doubt, but since these are not measurable in terms of money. there is no question of their accounting.

2. TRANSACTIONS ARE PROCESSED IN THREE DIFFERENT STAGES:

(a) Recording:

In the first stage the transactions are recorded chronologically in the books of accounts.

(b) Classifying:

In the second stage the transactions of the same or similar nature are classified and recorded separately.

(c) Summarising:

In the third stage all the necessary date and information are summarised on the basis of classified record of transactions and communicated to management and other interested persons.

(d) Interpretation:

In order to assertion the true position of a concern all the accounting data and information relating to it are analysed and interpreted.

All the above functions are performed on the basis of certain well-defined and well-coordinated rules and principles. An accountant must be familiar with all these rules and principles. In accounting we will study all these rules and principles.

Book-Keeping:

Book-keeping is the art of recording monetary transactions in the books of account in a proper manner. The books of accounts are recorded in such a way as will enable us to ascertain the complete and accurate result in the least possible time with minimum labour and cost.

Many authors have defined the terms 'Book-keeping' in different ways;

1. "Book-keeping means the recording of transactions, the record making phase of Accounting (it is only a small part of the field of Accounting and probably the simplest part." - Meigs, Johnson and Meigs.
2. "Book-keeping is the recording branch of Accounting." -- Encyclopaedia Britannica.
3. "Book-keeping is the art of recording in books of accounts the monetary aspect of commercial or financial transactions." Northcot.

BOOK-KEEPING VERSUS ACCOUNTING

A great deal of efforts goes into gathering and processing information about a concern before the facts end up in an accounting report. Much of the work required is clerical in nature and can be performed by office workers, machine and computers. The functions of Book-Keeping is to properly record the financial transactions in the books of account. But the function of Accounting is more extensive (it has many other functions to do except recording transactions, e.g. classification, summarisation and interpretation of transactions. Thus we see that Book-Keeping is confined to recording aspect of Accounting (it is a small and the simplest part of Accounting. Both represent two different phases of the main subject "Accountancy". Book-Keeping is the first stage, while Accounting is the final stage, that is why, it is said

that Accounting starts where Book-Keeping ends. The function of Book-Keeping ends with the recording of transactions in the books of account. But the function of Accounting is to classify the recorded transactions, summarise them, interpret them and collect and communicate necessary information to the management and other interested persons. Management performs its function on the basis of this information, e.g. laying down rules and regulations, taking so many vital decisions etc. Thus we may say that the function of Book-Keeping is primarily of clerical nature, while that of Accounting is concerned with organisational and administrative matters (it is more important and responsible.

Apparently, the functions of Book-Keeping seem to be less important than Accounting, but its necessity can hardly be denied. Just an article cannot be produced without raw material, similarly accounting function cannot be done without obtaining necessary data from Book-Keeping. Again, if there is any defect in raw material the article produced out of it will also be defective. Similarly, if there be any error or mistake in Book-Keeping, the accounting job will also be wrong and create anomalous situation. Thus we can conclude that 'Book-Keepers perform the routine, repetitive tasks of collecting and processing financial information. Accountants are responsible for designing the systems within which Book-Keepers work; supervising the day-to-day work of book-keepers; recording unusual and complex transactions, preparing, analysing and interpreting accounting reports; auditing the records; and performing a variety of other complex accounting activities.

ACCOUNTING VERSUS ACCOUNTANCY

The two words "Accounting" and "Accountancy" are often used to mean the same thing. But it is not correct. Accountancy is the main subject(Accounting is one of its branches. The word "Accountancy" is far extensive; i.e. the scope of accountancy is far wide and extensive compared to Accounting. It covers the entire body of theory and practice, e.g. Book-keeping, Accounting, costing, auditing, Taxation etc.

BRANCHES OF ACCOUNTING

In order to meet the ever increasing demands made on accounting by different interested parties (such as owners, management, creditors, taxation authorities etc.) the various branches of accounting have come into existence:

1. FINANCIAL ACCOUNTING:

The main purpose of financial accounting is to ascertain the true result (profit or loss) of the business operations during a particular period of time and to state the financial position of the business on a particular point of time. Financial accounting produces general purpose reports for use by the great variety of people who are interested in the organisation but who are not actively engaged in its day-to-day operation.

2. COST ACCOUNTING:

The main object of cost accounting is to determine the cost of goods manufactured or produced by the business. It also helps the management of the business in controlling the costs by indicating avoidable losses and wastes.

3. MANAGERIAL ACCOUNTING:

The object of this accounting is to communicate the relevant information periodically to the management of the business to enable it to take suitable decisions.

It should be remembered that in this book, we are concerned only with financial accounting. Financial accounting is the oldest and the other branches have developed from it. The objects of financial accounting can only be achieved by recording business transactions in a systematic manner according to a set of principles.

OBJECTS OF ACCOUNTING

1. Financial information is necessary in order to run a business in an efficient manner. Reliable information will be available only through keeping proper books of accounts.

2. Proper accounting is essential, if money is to be borrowed for the purpose of business. The lender will only agree to lend money when he is satisfied as to the solvency of the borrower. Information available from books of accounts is the means of measuring such solvency.

3. Cash in hand can be verified and any defalcation can be detected, if proper books of accounts are maintained.

4. Payment of sales tax and income tax is only possible if books of accounts are maintained.

5. In case of any dispute, books of accounts can be produced in the court of law as a documentary evidence.

6. Government fixes up fair prices, formulates industrial policy, prepares economic plans, decides import-export quotas and does many other functions on the basis of accounting information available from books of accounts.

IMPORTANT ACCOUNTING TERMS AND CONCEPTS

1. BUSINESS ENTITY:

Profit making organisations are known as businesses. There are three main types of businesses; those selling services (such as dry cleaners, Motor workshops, Beauty salons, airlines etc.); those selling goods (such as food sellers, automobile dealers etc.); those manufacturing goods (such as automobile manufacturers, fans industries, sugar mills etc.).

A business entity is an economic unit which enters into business transactions that must be recorded, summarised and reported. The entity (organisation) is regarded as separate from its owner or owners; the entity owns its own property and has its own debts. The purpose of accounting is to provide useful information about an organisation (an entity) to people who need such information but not about the personal affairs of the owner or owners. So it should be remembered that accounting is done for business activities (what is happening in the business organisation) and it is not concerned with the personal or private matters of the owner. For example, the owner purchases furniture for business use(this is a business activity and it should be recorded in books of accounts. But if he purchases furniture for his domestic use, it will not be considered as a business activity and will not be recorded in books of accounts. In the same way, the owner may have a personal bank account, a car, a house, and other property, but since these things are not a part of the business, they are not included in the record of the business unit. So, each organisation for which accounting is done is an independent entity, separate from its owners, managers, customers, creditors, and all other persons and entities with which it deals.

FORMS OF BUSINESS ORGANISATION

There are three main forms of business organisation;

(a) Single or sole proprietorship:

The simplest form of business organisation "to organise and operate" is a single or sole proprietorship. This is the most common form of ownership and is found in business such as small retail shops, service stations etc. The owner is the only one in control and makes all management decisions.

(b) Partnership:

In a partnership, ownership is divided between two or more persons who agree to share their property and skills to start and operate a business. Like the single proprietorship, a partnership business is simple to organise.

(c) . Joint Stock Company:

A joint stock company is formed under the Companies Ordinance, 1984 and has the legal right to act as a person. It may be owned by many people. A company has its own name, in which it can buy, own, and sell property; make contracts; borrow money; and take court action. The persons who have made investment in the company are known as shareholders.

2. GOODS OR MARCHANDISE

In accounting the word "Goods" has a special meaning. It refers to something which has been purchased by a trader for resale purposes or anything which has been manufactured for selling purposes. For example, if a trader purchases furniture for use in the business, it will not be regarded as "goods", but if it is purchased for resale, it will be regarded as "goods". The same article may be "goods" for one trader but may not be so to another trader. For example, furniture is not "goods" for a book seller; but it will be regarded as "goods" to a furniture -dealer.

Thus, cloth will be "goods" to a cloth dealer

Watches will be "goods" to a Watch dealer

Books will be "goods" to a Book - Seller

Stationery will be "goods" to a Stationery dealer.

But watches, books or stationery will not be considered as "goods" to a cloth dealer.

3. PURCHASES:

In accounting language the word "Purchases" has a special meaning. When saleable goods are bought in a business, it is said that "purchases" have been made. For example, to a cloth dealer, whenever cloth is purchased, it will not be necessary to mention that cloth has been purchased (simply it will be said that purchases have been made. On the other hand, if stationery is purchased, then it will be essential to mention that stationery has been purchased.

4. CASH PURCHASES:

If goods are purchased from a supplier and payment is made to him at the same time, such purchases are known as "Cash Purchases". For example, Mr. X purchased goods from a seller, Mr. Y, for Rs. 5000 on Ist January, 1991, and payment is made to the seller (Mr. Y) at the same date (1.1.1991), it will be a case of cash purchases.

5. CREDIT PURCHASES OR "PURCHASES ON ACCOUNT:

When goods are purchased from a seller and payment is not made to him at the same time, rather the payment is arranged to be made at some future date, such purchases are known as "credit purchases" or "Purchases on account". For example, Mr. A purchased goods from Mr. B for Rs. 5000 on Ist January, 1991 and Mr. A agreed to make the payment of goods on 15th January, 1991 (payment has not been made on 1.1.1991), it will be a case of credit purchases. On 15th January Mr. A will pay Rs. 5000 to

Mr. B.

6. PURCHASES RETURNS OR RETURNS OUTWARDS:

Goods once purchased may subsequently be sent back to the seller for certain reasons, i.e. goods are defective, not according to specification, damaged or below standard. Such return of goods to the seller

is known as "Purchases returns" or "Returns to suppliers". For example, we purchased 100 radio sets (goods) from Lahore Electronics for Rs. 15000. On receiving the delivery of goods, it is found that 10 radio sets are of inferior quality. The return of these 10 radio sets to the seller (Lahore Electronics) will be a case of purchases returns.

7. PURCHASES DISCOUNT AND SALES DISCOUNT:

The Concession given by the supplier to the buyer on purchases of goods is known as "Purchases discount" to the buyer and "Sales discount" to the seller (supplier).

8. ALLOWANCES:

Sometimes, the customers (buyers) find that goods purchased have minor defects. In that case, the seller may agree to reduce the price of damaged or defective goods to induce the buyer to keep the goods. Such reduction in price is known as "Purchases allowance" to the buyer and "Sales allowance" to the seller.

9. SALES:

We know that goods are purchased for selling purposes. When these goods are sold to customers at a specific price, it is said that sales have been made. For example, we purchased goods worth Rs. 5000 (our purchases). Suppose, these goods have been sold at a price of Rs. 6000 -- in accounting language it will be said that sales have been made at Rs. 6000. So goods sold are called "Sales".

10. CASH SALES:

If goods are sold to customers at a specific price and price of the goods is received from them at the time of sale of goods, such sales are known as "Cash sales". For example, we sold goods to a customer, Mr. A for Rs. 2000 on 10th January, 1991 and received the cash from him on the same date, it will be a case of cash sales.

11. CREDIT SALES:

If goods are sold to a customer and he does not pay the price of goods at the same time but agrees to make payment on some future date, the sales are called "credit sales" or "Sales on account." For example, we sold goods to Mr. X for Rs. 3000 on 15th January, 1991 and he agreed to make payment on 31st January, 1991, it will be a case of credit sales or sales on account.

12. SALES RETURNS OR RETURNS INWARDS:

If a customer to whom goods have been sold finds that the goods are defective, unsatisfactory, below standard or not according to specification, he may return these goods to the seller. To the seller, such return of goods is known as "Sales returns" or "Returns Inwards" or "Returns from customers.

13. TRADE DISCOUNT:

At the time of selling goods, the manufacturer or wholesaler allows retailers such a discount (concession). It is allowed at a certain percentage of the listed or catalogue price. For example, the list price of the goods is Rs. 30000, and the wholesaler allows a trade discount of 10% on the listed price to the retailer. It means the net price of the goods is 27000 (30000-3000). The trade discount enables the retailer to sell goods at the listed price; and the customer can be sure about the fair price of the goods. It may be noted that both the buyer and seller will record Rs. 27000 (not Rs. 30,000) in their books of account. In other words trade discount is not recorded in books of account. Thus, discount allowed by manufacturer or wholesaler at the time of selling goods to retailer as a deduction from the listed price or catalogue price, is called Trade Discount.

14 DEBTORS OR ACCOUNTS RECEIVABLE:

When goods are sold to the customers on credit basis (credit sales are made to customers), debtors come into existence. Debtors are the persons or customers to whom goods have been sold on credit basis and from whom the business is to receive money in near future. The accounts of such customers are known as "Accounts Receivable". For example, we sold goods to A for Rs. 3000, to B for Rs. 2000 and to C for Rs. 4000 on credit basis. The amount receivable from them (A, B and C) is known as "Debts" and the three customers, A, B and C are our debtors or accounts receivable.

15. CREDITORS OR ACCOUNTS PAYABLE:

When goods are purchased from the suppliers (sellers) on credit basis, creditors come into existence. Creditors are the persons or suppliers from whom goods have been purchased on credit basis and to whom the money is to be paid in near future. The accounts of such persons (suppliers) are known as accounts payable". Accounts payable means, the amount which a business expects to pay to its suppliers for goods purchased or services received from them on credit basis.

The person or business who will receive the money - Creditor.

The person or business who will pay the money -- Debtor.

16. CASH DISCOUNT:

It is a deduction or allowance given by a creditor to a debtor if the amount due is paid by the debtor before the due date, or it is a reduction in price (usually 2% or less) offered by manufacturers or wholesalers (creditors) to encourage customers (debtors) to pay their debts within a specified discounted period. For example, X sold goods to Y (a customer) for Rs. 1000 on credit basis. It means, X is creditor and Y is debtor. X offers an allowance of 2% to Y, if he will pay his debts within 15 days. It means, if Y pays his debts within 15 days, then he will pay only Rs. 980 (1000 – 20) to X. Such a discount is known as "Cash Discount".

17. CAPITAL OR OWNER'S EQUITY:

To understand this term, recall that business is an entity (organisation) separate from its owner or owners. Equities mean the sources of funds provided to start or to operate a business entity. Now the question is: who provides funds to a business unit. Mainly there are two sources of funds:

(a) Funds supplied by the owner/owners.

(b) Funds supplied by the external parties like bank etc.

So, the amount of cash or goods invested (supplied) by the owner/owners in a business unit is known as "capital" or owner's equity.

Or

Capital is the money or moneys worth borrowed by a business unit from its owner or owners.

Or

It is the claim or right of the owner/owners against the assets (properties etc. possessed by business) of the business.

Or

It is the source of funds provided by the owner/owners of the business.

Or

It is a part of the total equity which is supplied by the owner/owners.

For example, Mr. X started a business with Rs. 100000. Out of Rs. 100000, Rs. 70000 have been provided by the owner, X and Rs. 30,000 have been borrowed from a bank. Now, the equity (total funds) of the business is Rs. 100000 but owner's equity (capital) of the business is Rs. 70,000.

18. ASSETS:

Assets are the economic resources (having certain value) owned by a business on a particular date and which are expected to benefit the future operation of the business.

Or

Assets are the properties and possessions of a business both tangible (have physical existence) and intangible (have no physical existence).

Or

Assets are the things having certain value possessed by a business and receivable by a business on a particular date. For example, cash, furniture, building, land, machinery, stock of goods, Debtors or Accounts receivable, Bank balance, Goodwill etc.

19. LIABILITIES:

Liabilities are the debts or obligations of a business.

Or

The outsider's (creditors etc.) claims against the assets of the business are known as "Liabilities". There are two main parties who have claims against the assets of a business; (a) Owner's claim; (b) Outsiders' claims. The owner's claim against the assets of a business is known as owner's equity and outsider's claims against the assets of the business are known as "liabilities."

Or

Liabilities mean the total amount which a business is legally bound to pay to the outsiders, e.g. creditors, Bills payable, Accounts payable, Bank loan etc.

20. ACCOUNTING PERIOD:

It is a span of time for which a business generally prepares its financial statements (the statement prepared to know the profit or loss of a business and to know its financial position). Mostly the financial reports are prepared for one year but they may also be prepared for one month or for one quarter.

21. REVENUE:

All business organisations are engaged in providing goods or services to their customers. The amount which a business charges its customers for these goods or services, measures the revenue of the business.

Or

It is the price of goods sold or services provided by a business to its customers.

Or

Revenue is the inflow of assets (cash or debtors) in return for services performed or goods delivered (sold) during an accounting period.

Or

It is inflow of cash and debtors (receivable) in exchange for goods sold or services rendered during an accounting period.

For example, we sold goods to a customer for Rs. 1000 and he paid cash to us Rs. 1000. The revenue will be equal to inflow of cash Rs. 1000. But if the customer has paid only Rs. 500 and the remaining amounts he agreed to pay at some future date, again in that case the revenue will be equal to Rs. 1000 (inflow of cash Rs. 500 + Rs. 500 receivable).

TYPES OF REVENUE:

1. Sales: The total price of goods sold
2. Interest earned
3. Fees earned
4. Rent earned
5. Commission earned

22. EXPENSES:

Expenses are the costs of the goods and services used up in the process of obtaining revenue.

Or

Expenses are the cost of producing revenue in a particular accounting period.

Or

An expense is a sacrifice, or cost incurred to generate revenue.

For example, salaries for employees, telephone charges, rent of the building, insurance and transportation etc. All these costs are necessary to attract and serve the customers and thereby to obtain revenue. Expenses are sometimes also referred to as the "cost of doing business" or "expired costs".

23. NET INCOME OR NET PROFIT:

Net income or net profit is simply the amount by which the "revenue" for a particular period of time exceed the "expenses" incurred to generate them.

Net income or net profit = Revenue- Expenses:

ACCOUNTING PRINCIPLES

It has already been stated in this chapter that Accounting is the language of business through which economic information is communicated to all the parties concerned. In order to make this language easily understandable all over the world, it is necessary to frame or make certain uniform standards which are acceptable universally. These standards are termed as "Accounting Principles".

Accounting principles may be defined as those rules of action or conduct which are adopted by the accounts universally while recording accounting transactions. They are a body of doctrines commonly associated with the theory and procedures of accounting. They are serving as an explanation of current practices and as a guide for selection of conventions or procedures where alternatives exist. There principles can be classified into two groups.

(i) Accounting concepts (ii) Accounting conventions.

Accounting Concepts:

The term 'concepts' includes those basic assumptions or conditions on which the science of accounting is based. The following are the important accounting concepts:

(i) Separate Entity Concept (ii) Going concern concept
(iii) Money measurement concept (iv) Cost concept
(v) Dual Aspect concept (vi) Accounting period concept
(vii) Matching concept (viii) Realisation concept.

Accounting Conventions:

The term 'conventions' includes those customs or traditions which guide the accountant while communicating the accounting information. The following are the important accounting conventions:

(i) Convention of conservatism (ii) Convention of full disclosure

(iii) Convention of consistency (iv) Convention of materiality.

ACCOUNTING CONCEPTS

1. Separate Entity Concept:

Accounts are kept for entities, as distinguished from the persons who are associated with these entities. In recording events in accounting, the important question is: "How do these events affect the entity?" How they affect the persons who own, operate, or otherwise are associated with the entity is irrelevant. For example, when a person invests Rs.200,000 into business it will be deemed that the owner has given that money to the business which will be shown as a 'liability' in the books of the business. In case the owner withdraws Rs.30,000 from the business, it will change the position and the net amount payable by the business to the owner will be shown only as Rs.170,000.

The concept of separate entity is applicable to all forms of business organizations. For example, in case of a sole proprietorship or partnership business, though the sole proprietor or partners are not considered as separate entities in the eyes of law, but for accounting purposes they will be considered as separate entities.

2. Going Concern Concept:

According to this concept it is assumed that an entity is a going concern — that it will continue to operate for an indefinite time period there is no intention to liquidate the particular business venture in the foreseeable future. On account of this concept, the accountant while valuing the asset does not take into account the sale value of assets. Moreover, he charges depreciation on fixed assets on the basis of their expected life rather than on their market values.

For example, suppose that a company has just purchased a three-year insurance policy for Rs.45000. If we assume that the business will continue in operation for three years or more. We will consider the Rs.45000 cost of insurance as an asset which provides services to the business over a three-year period. On the other hand, if we assume that the business is likely to terminate in the near future, the insurance policy should be reported at its cancellation value i.e. the amount refundable upon cancellation.

Moreover, the concept applies to the business as a whole. When an enterprise liquidates a branch or one segment of its operations, the ability of the enterprise to continue as a going-concern is not impaired normally. The enterprise will not be considered as a going-concern when it has gone into liquidation.

3. Money Measurement Concept:

In financial accounting, a record is made only of information that can be expressed in monetary terms. In other words, no accounting is possible for an event or transaction which is not measurable in terms of money, e.g. passing an examination, delivering lecture in a meeting, winning a prize etc. These are events no doubt, but since these are not measurable in terms of money, there is no question of their accounting.

Measurement of business events in money helps in understanding the state of affairs of business in a much better way. For example, If a business owns, 1500 kg of stock, one car, 1500 square feet of building space etc. these amounts cannot be added to produce a meaningful total of what the business owns. However, if a these items are expressed in monetary terms such as stock Rs.24000, car Rs.300,000 and building Rs.500,000, all such items can be added in better way and precise estimate about the assets of the business will be available.

4. Cost Concept:

The concept is closely related to going concern concept. According to this concept. "An asset is ordinarily entered on the accounting record at the price paid to acquire it, and this cost is the basis for all subsequent accounting for the asset". If business buys a building for Rs.5,00,000, the assets would be recorded in the books at Rs.500,000, even if its market value at that time may be Rs. 550,000. In case a year later the market value of this asset comes down to Rs.450,000 it will ordinarily continue to be shown at Rs.500,000 and not at Rs.450,000.

The cost concept does not mean that the asset will always be shown at cost. It has also been stated above that cost becomes the basis for all future accounting for the asset. It means that asset is recorded at cost at the time of purchase but it may systematically be reduced in its value by charging depreciation.

5. Dual Aspect Concept:

The economic resources of an entity are called 'assets'. The claims of various parties against these assets are called 'equities'. There are two types of equities:

1. Liabilities, which are the claims of creditors (that is, everyone other than the owners of business) and
2. Owner's Equity, which is the claim of the owners of the business.

Since all of the assets of a business are claimed by someone (either by its owners or by it creditors) so we can say that

Assets = Equities

This is the fundamental accounting equation, which is the formal expression of the dual–aspect concept. As we shall see all accounting procedures are derived from this equation. To reflect the two types of equities, the equation is more commonly expressed as

Assets = Liabilities + Owner's Equity

Every transaction has a dual impact on the accounting records. Accounting systems are set up so as to record both of these aspects of a transaction; this is why accounting is called a double-entry system.

To illustrate the dual-aspect concept, suppose that Mr. A starts a business with a capital of Rs.30,000. There are two changes, first the business has cash (asset) of Rs.30,000 and second, the business has to pay to the proprietor a sum of Rs.10,000 which is taken as proprietor's capital. This expression can be shown in the form of following equation:

Cash (Assets) = Capital (Equities)
Rs. 30,000 = Rs.30,000.

Subsequently if the business borrows Rs.15000 from a bank, the new position would be as follows:

Assets = Equities
Cash Rs.30,000 + Bank Rs.15000 = Bank loan Rs.15000 + Capital Rs.30,000.

The term 'accounting equation' is also used to denote the relationship of equities to assets. The equation can be technically, stated as "for every debit, there is an equivalent credit". This has been explained in detail later in the next chapter.

6. Accounting Period Concept:

The users of financial statements need information that is reasonably current. Therefore, for financial reporting purposes , the life of a business is divided into a series of relatively short accounting periods of equal length. It is, therefore, absolutely necessary that after each accounting period the business must 'stop' and 'see back', how things are going. In accounting such accounting period is usually of a year.

At the end of each accounting period an income statement and a balance sheet is prepared the income statement discloses the profit or loss made by business during the year while balance sheet shows the financial position of business as on the last day of the accounting period.

7. The Matching Concept:

A significant relationship exists between revenue and expenses. Expenses are incurred for the purpose of producing revenue. In measuring net income for a period, revenue should be offset by all the expenses incurred in producing that revenue. This concept of offsetting expenses against revenue on the basis of "cause and effect" is called the Matching Concept.

The term 'matching' means appropriate association of related revenues and expenses. In matching expenses against revenue the question when the payment was made or received is 'irrelevant'. For example if a salesman is paid commission in January, 2001, for sales made by him in December, 2000. According to this concept commission expense should be offset against sales of December 2000 because this expense is incurred for producing revenue in December 2000. On account of this concept, adjustments are made for all outstanding expenses, accrued revenues, prepaid expenses and unearned revenues, etc., while preparing the final accounts at the end of accounting period.

8. Realisation Concept:

Accounting to this concept revenue should be recognized at the time when goods are sold or services are rendered. Sale is considered to be made at the point when the property in goods passes to the buyer and he becomes legally liable to pay. The following example will help to understand this point. Mr. A places on order to Mr. B for supply of certain goods. Mr. B sends goods to Mr. A 15 days after he has received the order and Mr. A makes payment 10 days after receipt of goods. In this case the sale will be presumed to have been made not at the time of receipt of the order for the goods or receipt of payment but at the time when goods are delivered to Mr. A.

ACCOUNTING CONVENTIONS

1. Conservatism:

According to this convention accounts follow the rule "anticipate no profit but provide for all possible losses", while recording business transactions. In other words, the Accountant follows the policy of "playing safe". On account of this convention, the inventory is valued at cost or market price whichever is less! Similarly a provision is made for possible bad and doubtful debts out of current year's profits. This concept affects principally the category of current assets.

The convention of conservation has been criticised these days as it goes against the convention of full disclosure. It encourages the accountant to create secret reserves (e.g. by creating excess provision for bad and doubtful debts, depreciation etc.), and the financial statements do not show a true and fair view of state of affairs of the business.

2. Full Disclosure:

According to this convention the users of financial statements (proprietors, creditors and investors) are informed of any facts necessary for the proper interpretation of the statements. Full disclosure may be made either in the body of financial statements, or in notes accompanying the statements. Significant financial events occurring after the balance sheet date, but before the financial statements have been issued to outsiders require full disclosure.

The practice of appending notes to the financial statements (such as about contingent liabilities or market value of investments or law suits against the company is in pursuant to the convention of full disclosure.

3. Consistency:

This convention states that once an entity has decided on one method, it should use the same method for all subsequent events of the same character unless it has a sound reason to change methods. If an entity made frequent changes in the manner of handling a given class of events in the accounting records, comparison of its financial statements for one period with those of another period would be difficult.

Consistency, as used here, has a narrow meaning. It refers only to consistency over time, not to logical consistency at a given moment of time. For example fixed assets are recorded at cost, but inventories are recorded at the lower of their cost or market value. Some people argue that this in inconsistent. Whatever the logical merits of this argument, it does not involve the accounting concept of consistency. This convention does not mean that the treatment of different categories of transactions must be consistent with one another but only that transactions in a given category must be treated consistently from one accounting period to the next.

4. Materiality:

The term materiality refers to the relative importance of an item or an event. An item is "material" if knowledge of the item might reasonably influence the decisions of users of financial statements. Accountants must be sure that all material items are properly reported in the financial statement.

However, the financial reporting process should be cost-effective — that is, the value of the information should exceed the cost of its preparation. In short, the convention of materiality allows accountants to ignore other accounting principles with respect to items that are not material. An example of the materiality convention is found in the manner in which most companies account for low–cost plant assets, such as pencil sharpness or wastebaskets. Although the matching concept calls for depreciating plant assets over their useful life, these low–cost items usually are charged immediately to an expense account. the resulting "distortion" in the financial statement is too small to be of any importance.

QUESTIONS

1. What is the need and importance of accounting?
2. What is accounting? How does it differ from Accountancy?
3. What do you mean by Book-Keeping? How does it differ from Accounting?
4. "Accounting begins where Book-keeping ends." Discuss the statement.
5. Explain the terms;
   - (a). Business entity
   - (b). Goods
   - (c). Purchases
   - (d). Purchases returns and allowances
   - (e). Cash Purchases & Credit Purchases
   - (f). Sales
   - (g). Cash sales & credit sales
   - (h). Sales returns & allowances
   - (k). Trade discount.
6. Explain the following concepts by giving examples;
   - (i) Debtors or Accounts Receivable.
   - (ii) Creditors or Accounts payable.
   - (iii) Cash Discount.
   - (iv) Capital or owner's equity.
   - (v) Assets.
   - (vi) Liabilities.
   - (vii) Accounting period.
   - (viii) Revenue.
   - (ix) Expenses.
   - (x) Net profit or net Income.
7. Explain the following concepts by giving examples;
   - (i) Separate Entity Concept
   - (ii) Cost Concept
   - (iii) Dual Aspect Concept
   - (iv) Matching Concept

CHAPTER - 2

TRANSACTIONS AND ACCOUNTING EQUATION

TRANSACTIONS AND ACCOUNTING EQUATION

The main function of an accountant is to record properly the financial transactions of a business concern in the books of accounts and to ascertain its true result at the year end. Thus transaction is the foundation of accounting - the first and formest element of accounting. In a word, it is the life and blood of Accounting. Hence the accountant must have a fair idea about the term "transaction."

In ordinary language "transaction" means exchange of something. But in Accounting it is used in a special sense. ***If the financial position of a business concern changes on the happening of an event which is measurable in terms of money, that event is regarded as a "transaction" in Accounting.***

Or

A business event which can be measured in terms of money and which must be recorded in books of account is called a "transaction".

WHAT IS AN EVENT?

EVENT:

In ordinary language "Event" means anything that happens. Human life is full of events. So many events take place in the family and social life of a person. The events may be classified into two:

(a) Monetary Events:

Events which are related with money, i.e. which change the financial position of a person are known as "monetary events". For example, daily shopping, marriage ceremony, birthday anniversary, marriage anniversary etc.

(b) Non-Monetary Events:

Events which are not related with money i.e. which do not change the financial position of a person are known as "non-monetary events". For example, winning a game, delivering a lecture in a meeting etc.

In business accounting only those events which change the financial position of the business and which call for accounting are recognised as "Events". In other words, all monetary events are regarded as "business transactions."

Remember, it is not that anything which results in exchange of something will be regarded as transaction. On the other hand, something may be regarded as a transaction even though it involves no exchange. For example, Rehman sends a price-list to his customer, Akram. This involves exchange of price-list between Rehman and Akram, yet it is not regarded as a transaction, because it is not measurable in terms of money and it does not change the financial position of both the persons. Again, suppose, goods worth Rs. 1000 are destroyed by fire. This does not involve any exchange, yet it is regarded as a transaction, because it is measurable in terms of money and it changes the financial position of the business.

It must be noted that an event, although measurable in terms of money, may not be regarded as a transaction. For example, we receive an order for supply of goods worth Rs. 1000. Although it is measurable in terms of money, it is not regarded as a transaction, since it has not changed the financial position. It will, however, be regard as a transaction when the goods are supplied according to the order.

It appears from the above discussion that the following two conditions must be satisfied in order that an event may be regarded as a transaction in Accounting;

1. The event must be measurable in terms of money.
2. The financial position of the business must change on account of that event.

FEATURES:

To become a transaction an event must have the following features;

1. THERE MUST BE TWO PARTIES:

No transaction is possible without two parties. Just as it takes two hands to clap, so it takes two parties for a transaction to take place. There cannot be a giver unless there is a receiver. Suppose, X borrows Rs. 10,000 from a bank. This is a transaction, since there are two parties here - X and bank.

2. THE EVENT MUST BE MEASURABLE IN TERMS OF MONEY:

An event will not be regarded as a transaction, unless it is capable of being measured in terms of money.

3. THE EVENT MUST RESULT IN TRANSFER OF PROPERTY OR SERVICE:

Suppose, we buy a motor-car from Saleem for Rs. 40000. This results in transfer of property from Saleem to us, so it is a transaction. Again suppose, we pay salary to our employee Rs. 2000. This results in transfer of service -- the employee renders service and we receive it. So it is a transaction.

4. THE EVENTS MUST CHANGE THE FINANCIAL POSITION OF THE BUSINESS:

Transaction takes place only when there is a change in the financial position of the business. The change in financial position may be of two kinds:

(a) Quantitative change:

This changes the total value of assets and liabilities of a business concern. Suppose, machinery of Rs. 50,000 is destroyed. This reduces the total value of the assets of the business. As a result, the financial position changes and hence it is a transaction.

(b) Qualitative change:

This causes increase or decrease in the different elements of assets or liabilities, but the value of total assets and total liabilities remains unchanged. Suppose, we buy machinery worth Rs. 50,000. This results in exchange of properties - cash Rs. 50,000 goes out of our possession and at the same time machinery of an equal value comes into our possession. This does not change the total value of our assets, but this causes a qualitative change in our financial position, hence it is a transaction.

CLASSIFICATION

Transactions may be divided into three groups:

1. CASH TRANSACTION:

If the value of a transaction in met is cash immediately, it is called cash transaction. For example, we buy furniture for Rs. 2000 from Asif and immediately pay him in cash. It is a cash transaction.

2. CREDIT TRANSACTION:

If the value of the transaction is not met in cash immediately, it is called credit transaction. In the above example, if we do not pay Asif Rs. 2000 immediately, it will be credit transaction.

3. PAPER TRANSACTION:

When there is no question of meeting the value of a transaction, it is regarded as a paper transaction. For example, I have lost Rs. 500. This changes my financial position-my properties decrease in value by Rs. 500. But there is no question of meeting the value of such a transaction. This is a paper transaction.

Transactions may again be divided into the following two classes;

1. EXTERNAL TRANSACTIONS:

A transaction taking place with an outside person or organisation, is called an external transaction. For example, a machine is purchased for Rs. 20,000 from Kashif Bros. This is an external transaction.

2. INTERNAL TRANSACTIONS:

A transaction with which no outside person or institution is involved, is called internal transaction. For example, loss of furniture by fire, decrease in the value of assets on account of use (depreciation) etc.

RULES FOR DECIDING WHETHER A TRANSACTION IS CASH OR CREDIT:

Sometimes transactions are worded in such a way that it becomes difficult to decide whether they are cash or credit transactions. The following rules will make the position clear;

1. A transaction is regard as a cash transaction if:

(a) The word "cash" is mentioned in the transaction. For example Bought goods for cash Rs. 5000 from Arshad.

(b) The name of the seller or buyer is not mentioned in the transaction. For example, Bought goods Rs.5000.

2. A transaction is regarded as a credit transaction if:-

(a) The words "on credit" or "on account" are mentioned in the transaction. For example, Bought goods Rs. 5000 on credit.

(b) The name of the seller or buyer is mentioned in the transaction and the word "Cash" is not mentioned. For example, Bought goods from Arshad Rs. 5000.

Thus we may conclude from the above discussion that every business transaction brings a double change in the financial position of the business. It brings a change in the assets, liabilities, owner's equity, expenses or revenues of a business.

ILLUSTRATION NO. 1

State with reasons whether the following events are transactions to my business;

1. **I started a business with Rs. 50,000.**
2. **I bought furniture for Rs. 2,000 for business use.**
3. **Submitted a tender for goods worth Rs. 10,000.**
4. **Appointed a cashier on a salary of Rs. 2,000 per month.**
5. **Paid salary to cashier Rs. 2,000.**
6. **I took away goods worth Rs. 500 from the business for my private use.**
7. **Paid salary Rs. 1,000 to Salesman of the business.**
8. **Paid rent of my house from my own funds.**

Solution:

Here transaction is to be considered from the viewpoint of my business, not from my personal viewpoint. So, an event changing the financial position of my business will be regarded as a transaction:

1. It is a transaction. It changes the financial position of the business -- Cash (asset) increases by Rs. 50,000 and owner's equity increases by an equal amount.
2. It is a transaction. It changes the financial position of my business--Furniture (an asset) increases by Rs. 2,000 and cash (an asset) decreases by an equal amount.
3. It is not a transaction. It does not change the financial position of my business.
4. It is not a transaction. Mere appointment of a cashier does not change the financial position of my business.
5. It is a transaction. It changes the financial position of my business-- cash (an asset) decreases by Rs. 2,000 and an expense (salary) increases by an equal amount.
6. It is a transaction. It changes the financial position of my business - goods decrease by Rs. 500 and owner's equity also decreases by an equal amount.
7. It is a transaction. It changes the financial position of my business cash (an asset) decreases by Rs. 1,000 and owner's equity also decreases by an equal amount.
8. It is not a transaction. It does not change the financial position of my business.

THE ACCOUNTING EQUATION

The three basic elements of accounting are assets, liabilities and owners' equity (capital). The assets represent the things of value that a business owns. The liabilities are the claims of the creditors against those assets. The owner's equity (capital) is the claim of the owner against those assets. Whatever is not claimed by the creditors belongs to the owner. As a result, the total claims against the assets are always equal to the total assets. This equality between the assets and the liabilities and the owner's equity is expressed by the "accounting equation".

Assets = Liabilities + Owner's Equity.

The two sides of the accounting equation must always be equal because the rights to all the assets of a business are owned by someone. The creditors have a claim against the assets of a business until the liabilities have been paid. The owner has a claim against the remaining assets of the business. If no liabilities exist, then the owners' equity will equal to the total assets.

A clear understanding of the accounting equation is essential, because most of accounting systems based on it. The equation actually identifies the claims (or rights) against the assets held by a business. The two sides represent different versions of the same thing. The left side of the equation, assets, consists of the "resources" (properties) held by the business; the right side of the equation, equities (creditor's claim and owner's claim against the assets) consists of the "sources".

Resources	=	**Sources**
Assets	=	**Claims against assets**

"The expression of the equality of an entity's assets with the claims against them is referred to as the accounting equation."

It should be remembered that the two sides of the equation are always equal because these two sides are merely two views of the same business resources. The assets side shows us "what resources" the business owns, the other side (liabilities and owner's equity) tells us "who supplied these resources" to the business and how much each group supplied.

EFFECT OF BUSINESS TRANSACTIONS UPON THE ACCOUNTING EQUATION:

Recall that every business transaction brings about a double change in the financial position of the business. The financial position of a business is represented by the accounting equation:

Assets = Liabilities + Owner's equity.

Regardless of whether a business grows or contracts this equality between the assets and the claims against the assets is always maintained. Any increase in the amount of total assets is necessarily accompanied by an equal increase on the other side of the equation, that is, by an increase in either the liabilities or the owner's equity. Any decrease in the amount of total assets is necessarily accompanied by an equal decrease in liabilities or owner's equity. Any expense incurred will decrease the owner's equity on one side and decrease cash on the other side of the equation. Any revenue earned will increase the owner's equity on one side and increase assets on the other side.

The effect of transactions upon the accounting equation can best be illustrated by taking a brand-new business as an example:-

SETTING UP A BRAND - NEW BUSINESS

Assume that Mr. Naveed decided to start a "shoes business" of his own, to be known as Naveed Shoes Company." The new business was started on Ist January, 1991, when Mr. Naveed invested Rs. 5,00,000 in his business. Recall that the business entity is kept separate from its owner.

The business unit has borrowed Rs. 5,00,000 from its owner. This is a first transaction of the business. It brought a double change in the financial position of the business-- an asset (cash) increased by Rs. 5,00,000 and a liability (owner's equity or capital) increased also by Rs. 5,00,000. In other words, this transaction is consisting of two elements;

1. The receipt of Rs. 500,000 cash
2. Supplied by the owner of the business.

TRANSACTION NO. 1

The initial accounting equation of the new business then appeared as follows;

	Assets	=	Liabilities	+	Owner's equity
1st Jan.	Cash				: Capital
	Rs. 500,000	=	Nil	+	Rs. 500,000

TRANSACTION NO. 2

Mr. Naveed purchased a building for Rs. 2,00,000. This transaction brought two changes-- cash (asset) decreased by Rs. 2,00,000 and Building (a new asset) increased by Rs. 2,00,000. Now the equation will be;

Assets	=	Liabilities	+	Owner's equity
Cash + Building				: Capital
Rs. 300,000 + 200,000	=	Nil	+	Rs. 500,000

It may be noted that there is no change on the right side of the equation. Simply one asset (cash) has been converted into another asset (Building). The two sides of the equation remains equal.

TRANSACTION NO. 3

He purchased furniture for Rs. 30,000. This transaction brought two changes-- cash (asset) decreased by Rs. 30,000 and furniture (a new asset) increased by Rs. 30,000. The equation will be;

Assets	=	Liabilities	+	Owner's equity
Cash + Building + Furniture				: Capital
Rs. 270,000 + 200,000 + 30,000	=	Nil	+	Rs. 500,000

Again there is no change on the right side of the equation and cash (asset) is converted into a new asset, furniture.

TRANSACTION NO. 4

He purchased goods (shoes) for Rs. 1,50,000 to stock up the business. This transaction brought two changes - cash,(asset) decreased by Rs. 1,50,000 and goods (stock) increased by Rs. 1,50,000. Again, there is no change on the right side of the equation. The equation will be:

Assets	=	Liabilities	+	Owner's equity
Cash + Building + Furniture + Goods				: Capital
Rs. 120000+200000 + 30000 + 150000	=	Nil	+	Rs. 500,000

TRANSACTION NO. 5

He sold goods costing Rs. 60,000 for Rs. 80,000 for cash. This transaction has brought three changes (a) cash (asset) increased by Rs. 80,000; (b) stock of goods decreased by Rs. 60,000; (c) the difference between sale price of goods (80,000) and cost price of goods (60,000) is profit of Rs. 20,000, it would increase the owner's equity by Rs. 20,000. The equation will be;

Assets	=	Liabilities	+	Owner's equity
Cash + Building + Furniture + Goods				: Capital
Rs. 120000+200000 + 30000 + 150000				500,000
+ 80000 - 60000	=	Nil	+	20,000
200000 + 200000 + 30000 + 90000	=	Nil	+	520000

TRANSACTION NO. 6

He purchased goods (shoes) for Rs. 30,000 on credit basis. This transaction has brought two changes Goods (stack) increased by Rs. 30,000 and a liability (creditor) is created, as goods have been purchased on credit basis: The equation will be as follows;

Assets	=	Liabilities	+	Owner's equity
Cash + Building + Furniture + Goods		Creditors	+	: Capital
Rs. 200000+200000 + 30000 + 90000		Nil	+	520,000
+ 30000	=	+ 30000	+	
200000 + 200000 + 30000 + 120000	=	30000	+	520000

TRANSACTION NO. 7

He sold goods costing Rs. 50,000 for Rs. 70,000 on credit basis. The result of this transaction is ---- (a) Stock of goods is reduced by Rs. 50,000; (b) A new asset (debtor) is increased by Rs. 70,000, as goods have been sold on credit basis; (c) The owner's equity is increased by Rs. 20,000 (the profit):

The equation will be;

Assets	=	Liabilities	+	Owner's equity
Cash + Building + Furniture + Goods + Debtors	=	Creditors	+ :	Capital
200000+200000 + 30000 + 120000 + Nil	=	30000	+	520,000
- 50000 + 70000	=		+	20000
200000 + 200000 + 30000 + 70000 + 70000	=	30000	+	540000

TRANSACTION NO. 8

Creditor was paid Rs. 30,000. The result of this transaction is -- a liability (creditor) is decreased by Rs. 30,000 and cash (asset) is also decreased by Rs. 30,000. Now, the equation is;

Assets	=	Liabilities	+	Owner's equity
Cash + Building + Furniture + Goods + Debtors	=	Creditors	+ :	Capital
200000+200000 + 30000 + 70000 + 70000	=	30000	+	540,000
- 30000	=	- 30000		
170000 + 200000 + 30000 + 70000 + 70000	=	Nil	+	540000

TRANSACTION NO. 9

Cash received from the debtor Rs. 40,000. The result of this transaction is -- cash (asset) increased by Rs. 40,000 and debtor (asset) decreased by Rs. 40,000. The equation is;

Assets	=	Liabilities	+	Owner's equity
Cash + Building + Furniture + Goods + Debtors	=	Creditors	+ :	Capital
170000+200000 + 30000 + 70000 + 70000	=	Nil	+	540,000
+ 40000 - 40000	=			
210000 + 200000 + 30000 + 70000 + 30000	=	Nil	+	540000

TRANSACTION NO. 10

Goods costing Rs. 25,000 were lost by fire. The result of this transaction is-- stock of goods is reduced by Rs. 25,000 and owner's equity is also decreased by Rs. 25,000 (as loss will be born by the owner). The equation is;

Assets	=	Liabilities + Owner's equity		
Cash + Building + Furniture + Goods + Debtors	=	Nil	+	Capital
210000+200000 + 30000 + 70000 + 30000	=	Nil	+	540,000
− 25000	=		−	25000
210000 + 200000 + 30000 + 45000 + 30000	=	Nil	+	515000

TRANSACTION NO. 11

He paid salaries and telephone bill Rs. 7,000. The result of this transaction is-- cash (asset) is decreased by Rs. 7,000 and owner's equity is also decreased by Rs. 7,000 (The expenses reduce the owners' equity). The equation is;

Assets	=	Liabilities + Owner's equity		
Cash + Building + Furniture + Goods + Debtors	=		+	Capital
210000+200000 + 30000 + 45000 + 30000	=		+	515,000
- 7000	=		−	7000
203000 + 200000 + 30000 + 45000 + 30000	=		+	508000

TRANSACTION NO. 12

He borrowed money from a bank (as bank loan) Rs. 50,000. The result of this transaction is -- cash (asset) is increased by Rs. 50,000 and a new liability (bank loan) is created (increased) by Rs. 50,000.

Assets	=	Liabilities + Owner's equity		
Cash + Building + Furniture + Goods + Debtors	=	Bank loan	+	Capital
203000+200000 + 30000 + 45000 + 30000	=	0	+	508,000
+ 50000	=	+ 50000		
253000 + 200000 + 30000 + 45000 + 30000	=	50000	+	508000

Resources	=	Sources;
(Assets)	=	(Equities)
558000	=	558000

It may be noted that equality of the two sides was maintained throughout the recording of the transactions.

ILLUSTRATION NO. 2

Show the effect of the following transactions upon the Accounting equation;

1990

June 1. Salman started his business with cash Rs. 1,00,000
5. Purchased furniture for cash Rs. 4,000
6. Purchased goods for cash Rs. 25,000
10. Paid Transportation on goods purchased Rs. 1,000
12. Sold goods for cash Rs. 15,000, costing Rs. 11,000
15. Purchased goods on credit basis for Rs. 15,000
19. Sold goods to Rashid on credit basis for Rs. 8,000, costing Rs. 6,500
25. Received cash from Rashid Rs. 4,000
28. Cash paid to creditor Rs. 9,000
30. Paid rent and salaries for the month Rs. 4,000

Solution:

ACCOUNTING EQUATION

	Assets				=	Liabilities	+	Owner's equity
	Cash	+Furniture	+Goods	+Debtors	=	Creditors	+	Capital
June 1	+100,000	0	0	0	=	0		100,000
June 5	- 4000	+ 4000			=			
Balances	96000	4000	0	0	=	0		100,000
June 6	- 25000		+25000		=			
Balances	71000	4000	25000	0	=	0		100,000
June 10	- 1000				=			- 1000
Balances	70,000	4000	25000	0	=	0		99000
June 12	+ 15000		-11000		=			+ 4000
Balances	85000	4000	14000	0	=	0		103000
June 15			+15000		=	+ 15000		
Balances	85000	4000	29000	0	=	15000		103000
June 19			- 6500	+ 8000	=			+ 1500
Balances	85000	4000	22500	8000	=	15000		104500
June 25	+4000			- 4000	=			
Balances	89000	4000	22500	4000	=	15000		104500
June 28	- 9000				=	- 9000		
Balances	80000	4000	22500	4000	=	6000		104500
June 31	- 4000				=			- 4000
Balances	76000	+ 4000	+ 22500	+ 4000	=	6000	+	100500

Total Assets	=	Liabilities	+ Owner's equity
106500	=	6000	+ 100500

ILLUSTRATION NO. 3

Mr. Salman commenced his business on Ist July, 1990. His assets, liabilities and capital are indicated by accounting equation given below. During July, 1990, he had various transactions which affected the accounting equation. Give the transactions which had affected the accounting equation:

	Assets				=	Liabilities	+	Owner's equity
Date	Cash	+ Building	+Furniture	+Goods	=	Creditors	+	Capital
July,	150,000	+500,000	+40,000	0	=	170,000		+ 520,000
(1)	- 40,000			+40,000	=			
	110,000	+ 500,000	+ 40,000	+ 40,000	=	170,000		+ 520,000
(2)	+ 15000			- 11000	=			+ 4000
	125000	+ 500,000	+ 40,000	+ 29000	=	170,000		+ 524000
(3)	+ 14000			- 16000	=			- 2000
	139000	+ 500,000	+ 40,000	+ 13000	=	170,000		+ 522000
(4)	- 50,000				=	- 50,000		
	89000	+500,000	+40,000	+13000	=	120,000		+ 522000
(5)		- 100,000						- 100,000
	89000	+ 400,000	+ 40,000	+ 13000	=	120,000		+ 422000
(6)				+ 30,000	=	+ 30,000		
	89000	+ 400,000	+40,000	+43000	=	150,000		+ 422000
(7)			- 8000					- 8000
	89000	+ 400,000	+ 32000	+ 43000	=	150,000		+ 414000
(8)	- 5000							- 5000
	84000	+ 400,000	+ 32000	+43000	=	150,000		+ 409000

Solution:

1 Goods purchased for cash Rs. 40,000
2. Goods sold for Rs. 15,000 costing Rs. 11,000
3 Goods sold for Rs. 14,000 costing Rs. 16,000
4. Cash paid to creditors Rs. 50,000
5. Building depreciated by 20 %.
6. Goods purchased for Rs. 30,000 on credit basis
7. Furniture depreciated by 20 %.
8. Expenses paid Rs. 5,000.

ILLUSTRATION NO. 4

Compute the missing amounts in each of the following three cases:

	Assets	=	Liabilities	+	Owner's equity
(a)	3,72,000	=	2,28,000	+	?
(b)	?	=	1,50,000	+	1,00,000
(c)	8,20,000	=	?	+	3,80,000

Solution:

ACCOUNTING EQUATION:

Assets = Liabilities + Owner's Equity

Or Assets - Liabilities = Owner's equity

So (a) 3,72,000 - 2,28,000 = {1,44,000}

(b) Assets = Liabilities + Owner's equity

{2,50,000} = 1,50,000 + 1,00,000

(c) Accounting equation may be expressed as follows:

Assets - Owner's Equity = Liabilities

8,20,000 - 3,80,000 = {4,40,000}

QUESTIONS

1. What is a transaction in a business? How does it differ from an event? what are the features of a transaction?
2. What are different types of business transactions?
3. State with reasons which of the following events may be regarded as transactions for Mr. Akram, a trader;
   1. Mr. Akram started business with Rs. 100,000
   2. He bought furniture for Rs. 10,000 and opened a bank account with Rs. 30,000
   3. He placed an order with Rehman & Sons for the purchase of goods worth Rs. 15000.
   4. He appointed Rizwan as accountant at a salary of Rs. 1500 per month
   5. He bought goods for Rs. 5000
   6. He agreed to sell goods for Rs. 10,000 to Rashid
   7. There was a theft of cash for Rs. 2000 in his business
   8. He dismissed Rizwan from service
   9. He paid Rizwan Rs. 5000 as compensation from his service
   10. He withdrew cash of Rs. 2000 for his private use

Ans: *[Transactions; 1,2,5,7,9,10]*

4. What do you mean by on Accounting Equation?
5. Briefly describe the effects of various common transactions on accounting equation.

PROBLEMS

1. Compute the missing amount in each of the following cases;

	Assets	Liabilities	Owner's equity
(i)	1,05,000	?	70,000
(ii)	?	35,000	90,000
(iii)	75,500	40,200	?
(iv)	99,500	?	50500
(v)	?	95,000	1,03,000

Ans: *[(i) L= 35,000; (ii) A = 1,25,000; (iii) O.E = 35,300; (iv) L = 49,000; (v) A = 1,98,000]*

2. Show the effects of following transaction on Accounting Equation:

(i) Mr. Saleem started business with Goods Rs. 20,000 Building Rs. 50,000 & Cash Rs. 55000.

(ii) Purchases goods on account for Rs. 15000.

(iii) Sold goods on account for Rs. 20,000.

(iv) Cash of Rs. 10,000 deposited into bank.

(v) Paid cash to supplier of goods Rs. 10,000.

(vi) Received cash from customers Rs. 15000.
(vii) A part of building costing Rs. 15000 was destroyed by fire.
(viii) He made additional investment by cheque Rs. 10,000.
(ix) Paid salaries Rs. 2000 by cheque.
(x) Goods returned to supplier amounting to Rs. 2000.

Ans: *[Rs. 121,000].*

3. **Show the effects of following transactions on the Accounting Equation;**

(a) Mr. Naeem started business with cash Rs. 2,00,000
(b) He purchased furniture for Rs. 10,000
(c) He purchased goods worth Rs. 50,000 for cash
(d) He purchased goods worth Rs. 30,000 on credit
(e) He bought office equipment for Rs. 15,000
(f) He sold goods for Rs. 30,000 costing Rs. 25,000
(g) He sold goods to Saleem for Rs. 20,000 costing Rs. 17,000 on credit basis
(h) He withdrew cash Rs. 3,000 for his personal use
(i) He made additions investment in cash Rs. 15,000
(j) Cash paid to creditors Rs. 25,000
(k) Cash received from Saleem Rs. 15,000
(l) He paid salaries Rs. 3,000
(m) He paid rent of building Rs. 2,000.

Ans: *[Rs. 220,000].*

4. **On Ist January, 1990, the balances of M/s Khan Bros. are as follows;**

Assets		Liabilities & Owner's equity	
Cash	Rs. 25000	Creditors	40000
Debtors of goods	17000	Capital	94000
Stock of goods	22000		
Building	70,000		
	134000		134000

Transactions during the month of January;

Jan:

1. Purchased goods for cash Rs. 4,000 subject to a trade discount of 10%
5. Sold goods for cash Rs. 12,000 Costing Rs. 10,500
7. Cash paid to creditors Rs. 25,000
9. Sold goods for cash Rs.5,000 and as credit basis Rs.3,000 costing Rs.6,000.
11. Goods returned by a customer Rs. 2,000 costing Rs. 1,900
15. Cash received from debtors Rs. 14,000
18. Cash paid for furniture purchased for owner's domestic use Rs. 1,000
22. Depreciation on building Rs. 1,400
29. Paid telephone bill Rs. 600
30. Paid salaries Rs. 3,000.

Req. Show the effects of above transactions on the accounting equation.

Ans: *[Rs. 106400].*

5. **On 1st March 1998, the balances of M/S Aamir Bros. are as follows:**

Assets		Liabilities	
Cash	20,000	Accounts Payable	15,000
Accounts Receivable	15,000	Capital	?
Merchandise Inventory	24,000		
Furniture	30,000		

Transactions during the month of March 1998.

March:

04. Goods costing Rs. 6,000 are sold for Rs. 10,000 subject to 5 % trade discount.
10. Office supplies of Rs. 5000 are purchased from Khurram Traders.
14. Half of the Accounts Payable on 1.3.1998 are paid.
22. Paid for stationery purchased Rs. 1000.
24. Depreciation on furniture Rs. 1500.
25. Rs. 7000 received from accounts receivables.
28. Purchased goods for cash Rs. 5000 subject to 5 % trade discount.
30. Paid Rent for the month Rs. 2000.

Ans: *[Rs. 86500].*

6. **Mr. Nasir's business position on Ist January, 1990, is shown by an accounting equation given below. Each line is designated by a letter which indicates effect on the equation of a particular transaction. Describe each of the transactions:**

	Cash +	*Furniture*	*+ Goods*	*+ Debtors*	=	*Liabilities*	*+ Owner's Equity*
(a)	2000	+ 2000	+ 8000 + 2500	+ 2000	= =	——— + 2500	+ 14000
(b)	2000 + 3000	+ 2000	+ 10500 - 2700	+ 2000	=	2500	+ 14000 + 300
(c)	5000 - 1950	+ 2000	+ 7800	+ 2000	= =	2500 - 2000	+ 14300 + 50
(d)	3050 - 400	+ 2000	+ 7800	+ 2000	=	500	+ 14350 - 400
(e)	2650 + 1450	+ 2000	+ 7800	+ 2000 - 1500	= =	500	+ 13950 - 50
(f)	4100	+ 2000 - 200	+ 7800	+ 500	= =	500	+ 13900 - 200
(g)	4100 + 1500	+ 1800	+ 7800 - 1700	+ 500	= =	500	+ 13700 - 200
	5600	+ 1800	+ 6100	+ 500	=	500	+ 13500

CHAPTER - 3

ANALYSIS OF BUSINESS TRANSACTIONS AND DOUBLE ENTRY SYSTEM

ANALYSIS OF BUSINESS TRANSACTIONS AND DOUBLE ENTRY SYSTEM

Change in financial position means a change in five basis elements of accounting.

We have already seen in the previous chapter that how different business transactions make change in the accounting equation (financial position) of a business concern. In accounting equation only three basic elements of accounting (the assets, liabilities and capital) have been considred. But, practically there are five basic elements of accounting, the assets, liabilities, capital, expenses and revenues. The students are required to remember an important principle while making the analysis of business transactions that ***"Every business transaction brings about at least a double change in the financial position of a business concern".*** These two changes may take place in any one or two basic elements of accounting. There is no exception to this principle. For example, Mr. Asif purchases machinery worth Rs. 50,000. This is a business transaction. It will bring two changes — machinery increases by Rs. 50,0000 (an asset) and cash decreases by Rs. 50,000 (an asset). So, both the changes have taken place in assets (an element of accounting). Similarly, if he buys this machinery on credit basis from Mr. A, again it will bring two changes – machinery increase by Rs. 50,000 (an asset) and a liability increases by Rs. 50,000 (amount payable to Mr. A).

Now let us see how the analysis of various business transactions is made:

TRANSACTION NO. 1

Mr. Rizwan invests Rs. 100,000 to comence his business.

ANALYSIS:

Two changes have taken place because of this transaction:

1. Cash is increased in the business by Rs. 100,000 (an asset).
2. Capital or Owner's equity is increased by Rs. 100,000 (an internal liability of the business).

TRANSACTION NO. 2

He open current account with ABL and deposits Rs. 30,000.

ANALYSIS:

This transaction has brought two changes:

1. Decrease in Cash balance by Rs. 30,000 (an asset).
2. Increase in Bank balance by Rs. 30,000 (an asset).

TRANSACTION NO. 3

He borrows Rs. 50,000 from Mr. Saleem at 12 % interest per annum.

ANALYSIS:

The two changes are:

1. Increase in Cash balance by Rs. 50.000 (an asset).
2. Increase in creditor by Rs. 50,000 (a liability).

TRANSACTION NO. 4

He purchases furniture worth Rs. 20,000 for cash.

ANALYSIS:

The two changes are:

1. Increase in furniture by Rs. 20,000 (an asset).
2. Decrease in cash balance by Rs. 20,000 (an asset)

TRANSACTION NO. 5

He purchases goods (saleable goods) from Mr. Afzal for Rs. 25000 and paid cash Rs. 15.000.

ANALYSIS:

There are three changes in this business transaction:

1. Increase in purchases (goods) by Rs. 25000 (an expense)
2. Decrease in Cash balance by Rs. 15000 (an asset)
3. Increase in creditor Mr. Afzal by Rs. 10,000 (a liability).

In this transaction goods worth Rs. 25000 have been purcahsed and the amount paid in cash to Mr. Afzal is Rs. 15000, which means the balance amount of Rs. 10,000 is payable to him, so it is liability of the business.

TRANSACTION NO. 6

He sells goods for cash Rs. 9000.

ANALYSIS:

There are two changes:

1. Increase in cash by Rs. 9000 (an asset).
2. Decrease in goods or increase in sales (a revenue) by Rs. 9000.

TRANSACTION NO. 7

He sells goods for Rs. 5000 to Mr. Naeem on credit basis.

ANALYSIS:

The two changes are:

1. Increase in debtor Mr. Naeem (an asset) by Rs. 5000
2. Decrease in goods or increase in sales (a revenue) by Rs. 5000.

TRANSACTION NO. 8

He purchases stationery for Rs. 3000.

ANALYSIS:

The two changes are:

1. Increase in stationery by Rs. 3000 (a consumable asset).
2. Decrease in Cash balance by Rs. 3000 (an asset).

TRANSACTION NO. 9

He purchases a weighing scale and a safe for Rs. 10,000 and pays by cheque.

ANALYSIS:

The two changes are:

1. Increase in weighing scale and safe by Rs. 10,000 (an asset).
2. Decrease in bank balance by Rs. 10,000 (an asset).

TRANSACTION NO. 10

He pays Rs. 6000 to Mr. Afzal on account.

ANALYSIS:

Mr. Afzal is creditor (a liability) of the business for Rs. 10,000 and now Rs. 6000 have been paid to him and the balance of Rs. 4000 is still payable to him. The two changes are:

1. Decrease in cash by Rs. 6000 (an asset).
2. Decrease in creditor Mr. Afzal by Rs. 6000 (a liability).

TRANSACTION NO. 11

He returns defective goods to Mr. Afzal worth Rs. 1000.

ANALYSIS:

In this transaction, goods purchased from Mr. Afzal have been returned to him, so there will be a reduction in the amount payable (a liability) to Mr. Afzal by Rs. 1000. The two changes are:

1. Decrease in goods or increase in purchases returns (Decrease in expense), by Rs. 1000
2. Decrease in creditor Mr. Afzal by Rs. 1000 (a liability).

TRANSACTION NO. 12

Goods are returned by Mr. Naeem Rs. 500 to the business.

ANALYSIS:

In this transaction goods sold to Mr. Naeem have been returned by him to the business Rs. 500, so there will be a reduction in the amount receivable from Mr. Naeem (a debtor) by Rs. 500. The two changes are:

1. Decrease in debtor Mr. Naeem by Rs. 500 (an asset).
2. Increase in goods or increase in Sales returns (decrease in revenue) by Rs. 500.

TRANSACTION NO. 13

Cash paid to Mr. Afzal Rs. 2800 in full satisfication of his claim of Rs. 3000.

ANALYSIS:

The amount payable to Mr. Afzal (a creditor) is Rs. 3000. In this transaction, it is assumed that payment is made to him before the due date and that is why, business is receiving a cash discount of Rs. 200 (a revenue) from Mr. Afzal. In full satisfaction. we mean by paying him Rs. 2800. the liability is settled in full (Rs. 3000). There are three changes in this transaction:

1. Decrease in Cash Rs. 2800 (an asset).
2. Decrease in creditor Mr. Afzal (a liability) by Rs. 3000.
3. Increase in discount received by Rs. 200 (a revenue).

TRANSACTION NO. 14

Cash received from Mr. Naeem (a debtor) Rs. 4400 in full satisfaction of his debts of Rs. 4500.

ANALYSIS:

The amount receivable from Mr. Naeem is Rs. 4500. In this transaction, it is assumed that Mr. Naeem is paying his debts before the due date and that is why. business allows him a discount (a concession) of Rs. 100 (an expene or loss to the business). In full satisfaction, we mean by receiving Rs. 4400 from him. his account is settled in full (Rs. 4500). These are three changes in this business transaction:

1. Increase in Cash Rs. 4400 (an asset).
2. Decrease in debtor Mr. Naeem by Rs. 4500 (an asset).
3. Increase in discount allowed by Rs. 100 (an expense or loss).

TRANSACTION NO. 15

Cash withdrawn from the bank for business use Rs. 5000.

ANALYSIS:

The two changes are:

1. Increase in Cash balance Rs. 5000 (an asset).
2. Decrease in bank balance Rs. 5000 (an asset).

TRANSACTION NO. 16

Interest is paid on money borrowed from Mr. Saleem Rs. 500.

ANALYSIS:

There are two changes:

1. Increase in interest expense (an expense incurred) by Rs. 500.
2. Decrease in Cash balance Rs. 500 (an asset).

TRANSACTION NO. 17

Cash paid to Mr. Saleem Rs. 20,000 (repayment of borrowed money).

ANALYSIS:

The two changes are:

1. Decrease in cash balance Rs. 20,000 (an asset).
2. Decrease in creditor Mr. Saleem by Rs. 20,000 (a liability).

TRANSACTION NO. 18

Cash withdrawn by the owner (Mr. Rizwan) Rs. 3000 and goods taken by him Rs. 1000 for his personal use.

ANALYSIS:

There are three changes in this business transaction:

1. Decrease in cash balance Rs. 3000 (an asset).
2. Decrease in goods (purchases) by Rs. 1000 (a decrease in expense).
3. Decrease in capital or owner's equity or increase in Drawings of the owner by Rs. 4000.

TRANSACTION NO. 19

Cash given away as charity Rs. 500 and goods given away as charity Rs. 100.

ANALYSIS:

There are three changes:

1. Decrease in cash balance Rs. 500 (an asset).
2. Decrease in goods (purchases) by Rs. 100 (a decrease in expense).
3. Increase in charity by Rs. 600 (an expense or loss).

TRANSACTION NO. 20

Goods distributed as free samples for advertisement purposes Rs. 2000.

ANALYSIS:

There are two changes:

1. Decrease in goods (purchases) by Rs. 2000 (a decrease in expense).
2. Increase in advertisement expenditures by Rs. 2000 (an expense incurred).

TRANSACTION NO. 21

Goods lost by theft worth Rs. 1500.

ANALYSIS:

There are two changes:

1. Decrease in goods (purchases) by Rs. 1500 (a decrease in Expense).
2. Increase in loss by theft by Rs. 1500 (an expense or loss)

TRANSACTION NO. 22

Stationery consumed during the month worth Rs. 2000.

ANALYSIS:

Stationery worth Rs. 3000 was purchased at the beginning of the month. During the month stationery of Rs. 2000 have been used. There are two changes:

1. Decrease in stationery Rs. 2000 (a decrease in asset).
2. Increase in stationery expense Rs. 2000 (an expense).

TRANSACTION NO. 23

Salaries paid for the month Rs. 4000.

ANALYSIS:

There are two changes:

1. Increase in salaries Rs. 4000 (an expense incurred).
2. Decrease in Cash balance Rs. 4000 (an asset).

TRANSACTION NO. 24

Rent of the building Rs. 3000 and Electricity bill Rs. 1000 paid by cheque.

ANALYSIS:

There are three changes:

1. Increase in Rent Rs. 3000 (an expense incurred).
2. Increase in Electric charges Rs. 1000 (an expense incurred).
3. Decrease in bank balance Rs. 4000 (an asset).

In all the above discussed transactions, it may be observed that in every business transaction there are at least two changes and in some cases there are more than two changes. All these changes are recorded in the books of accounts of the business in separate accounts. Every change is supposed to be recorded in a separate account.

NOTE:

Discussion about account and how a change is recorded in an account is made later in this chapter.

DOUBLE ENTRY SYSTEM:

We have already seen in this chapter that every business transaction causes atleast two changes in the financial position of a business concern at the same time – hence, both the changes must be recorded in the books of account. Otherwise, the books of accounts will remain incomplete and the result ascertained therefore will be inaccurate. For example, we buy machinery for Rs. 50,000. Obviously, it is a business transaction. It has brought two changes – machienry increases by Rs. 50,000 and cash decreases by an equal amount. While recording this transaction in the books of accounts, both the changes must be recorded. In accounting language these two changes are termed as "a debit change" and "a credit change"

(the detail about these two terms is given later in this chapter under the topic "Account"). Thus we see that for every transaction there will be two entries – one debit entry and another credit entry. For each debit there will be a corresponding credit entry of an equal amount. Conversely. for every credit entry there will be a corresponding debit entry of an equal amount. So. **the system under which both the changes in a transaction are recorded together – one change is debited. while the other change is credited with an equal amount–is known as Double Entry system.**

Locus Pacioli. an Italian worte a first book on double entry system in 1494. It is regarded as the best and the only scientific method of accounting system universally accepted throughout the world. It has been built on well defined rules and principles which is the foundation of modern Accountancy.

The fundamental principle of this system lies in analysing the two changes (parties) involved in business transactions and properly recording of both the changes in the books of accounts. There is no exception to this principle. If a complete picture of the transactions is to be reflected through books of accounts. the double entry system must be duly observed. Otherwise. the books of accounts will fail to provide complete information and the very objective of accounting will be defeated.

In this connection, the successive processes of the Double Entry System may be noted:

(1) JOURNAL:

First of all, transactions are recorded in a book known as Journal.

(2) LEDGER:

In the second process. the transactions are classified in a suitable manner and recorded in another book known as Ledger.

(3) TRIAL BALANCE:

In the third process, the arithmetical accuracy of he books of account is tested by means of Trial Balance.

(4) FINAL ACCOUNTS:

In the fourth & final process the result of the full year's working is determined through Final Accounts.

All the above process have been discussed in details in the following Chapter.

ADVANTAGES:

Double Entry system is acknowledged as the best method of accounting in the modern world. The following advantages are derived from it:

(1) Under this system both the aspects of each and every transaction are recorded. So, it is possible to keep complete account.

(2) Since both the aspects of a transaction are recorded, for each debit there must be a corresponding credit of an equal amount. Therefore, total debits must be equal to total credits. In fact, it is possible to verify the arithmetical accuracy of the books of account by ascertaining whether the two sides become equal or not through a process known as **Trial Balance.**

(3) Under this system **Profit & Loss Account** can be prepared easily by taking together all the accounts relating to incomes or revenues and expenses or losses and thereby the result of the business can be ascertained.

(4) A **Balance Sheet** can be prepared by taking together all the accounts relating to assets and liabilities and thereby the financial position of the business can be assessed.

(5) Under this system mistakes and defalcations can be detected – this exerts a moral pressure on the Accountant and his staff.

(6) Under this system necessary statistics are easily available so that the management can take appropriate decision and run the business efficiently.

(7) All the necessary details about a transaction can be obtained quickly and easily.

(8) The total amount owed by debtors and the total amount owed to creditors can be ascertained easily.

(9) Sale–purchase of goods, stock, revenue, expenses and profit or loss of different years can be compared and the success or failure of the business measured. Thereafter the causes of failure can be found out and necessary remedial meausres taken to ensure success of the business.

DISADVANTAGES:

Despite so many advantages of the system, it has a few disadvantages which are as follows:

(1) Under this system each transaction is recorded in books in two stages (Journal & Ledger) and on two sides (Debit & Credit). This result in increase in the number and size of books of account and creation of various complications.

(2) It invovles time, labour and money. So it is not possible for small concerns to keep accounts under this system.

(3) It requires expert knowledge to keep accounts under this system.

(4) As the system is complex, there is greater possibility of committing errors and mistakes.

It is clear from the above discussion that the advantages of Double Entry System far outweigh its disadvantages. So, it is regarded as the best system in the modern world.

SINGLE ENTRY SYSTEM

From the very name of the system it aparently seems that a system in which only one aspect of a transaction is recorded, is called Single Entry System. But in fact it is not so. This system does not observe any systematic rule. Under this system, some transactions are recorded on both the sides like Double Entry System, some are recorded on one side only, while some others are not recorded at all. According to **Arthur Fieldhouse,** "Single Entry is faulty, incomplete, inaccurate, unscientific and unsystematic style of account–keeping". For this reason many persons call the Single Entry System as **Accounting from Incomplete**

Records. Single Entry system is a misnomer. So it is very difficult to give a proper definition of the system. On the whole **"Single Entry is that which is not Double-Entry"**. It can be said that **this system is nothing but a mixture of Double Entry, Single Entry and No Entry.**

DISTINCTION BETWEEN DOUBLE ENTRY SYSTEM AND SINGLE ENTRY SYSTEM

The following points of distinction are observed between the two systems:

Double Entry System	Single Entry System
1. Both the aspects of a transaction are recorded in it. So complete analysis of a transaction is possible.	1. For some transactions both the aspects are recorded, while for some other transactions only one aspect is considered. Again, some transactions are not recoded at all. Thus, complete analysis of a transaction is ~~not~~ always possible.
2. All the different classes of accounts – Assets A/c, Liability A/c, Capital A/c, Expenses A/c and Revenue A/c – are maintained.	2. Only Cash A/c and Personal Accounts are maintained.
3. It is possible to verify the arithmetical accuracy of books through Trial Balance.	3. As under this system both the aspects of all transactions are not recorded, it is not possible to prepare Trial Balance and thereby verify arithmetical accuracy of books of account.
4. In this system Profit & Loss A/c can be prepared and the result of the business can be determined thereby.	4. Under this system no account is maintained in respect of income or expenditure. So it is not possible to prepare Profit & Loss A/c. However, profit or loss is determined through a statement by comparing closing capital with opening capital, but it is not so reliable.
5. The financial position of the business can be ascertained through Balance Sheet.	5. No account is maintained in respect of assets and liabilities. So, Balance Sheet cannot be prepared. However, a statement of Affairs is prepared on the lines of Balance Sheet. But it is not regarded as a reliable document, since the values of assets and liabilities are not obtained from the regular books of account.

6. All the necessary information is available from this system at any time.	6. As no detailed record is maintained in respect of all transactions full information is not available from the books of account.
7. It is easier to detect mistakes and defalcations under this system.	7. Mistakes and defalcations cannot be detected easily.
8. This system is based on scientific method.	8. It does not follow any scientific rules.
9. Accounting is complex and costly.	9. Accounting is less complex and less costly.
10. Accounting under this system calls for men with specialised know ledged.	10. Men with common knowledge will do in this case.
11. In the first stage each transaction is recorded in a book named 'Journal' and therefrom it is posted in another book named 'Ledger' in the second stage.	11. There is no rule here as such.
12. Since accounting under this system requires a large number of employees. it may not be possible to maintain secrecy.	12. Here secrecy can be maintained, since only a few persons are sufficient for performing accounting job.

WHAT IS AN ACCOUNT ?

In business concerns. numerous transactions take place every day. For example. goods are sold to various customers every day. purchases are made from suppliers. cash is paid to creditors and is received from debtors. expenses are paid etc. All these transaction should be properly analysed and recorded. Again. the concept of double change in a business transaction is important to keep in mind. To record these changes different accounts are maintained in the Ledger (Debited discussion about Ledger is made in chapter No. 5). Now, what is an account? **Account is the individual record of an asset. a liability. a revenue. an expense or capital in a summarized manner.** For example. the individual record of cash (an asset) is known as Cash Account, the individual record of purchases is Purchases Account. the individual record of owner is Capital Account, the individual record of sales is Sales Account. In the same way there are so many accounts which are opened in the Ledger like Salary Account, Machinery Account. Furniture Account etc. How many accounts there should be in the Ledger of a business? It depends upon the nature and size of the business.

Generally one full page is fixed in the Ledger for each account. But it depends. how many times the changes take place in that particular account. Some accounts are very busy accounts like Cash Account, Bank Account and Sales Account. Obviously, for such accounts one page for each will not be enough and so. they need more pages in the ledger to be fixed. In some accounts. changes take place only once or twice in a year. so only one page will be enough. e.g. Machinery Account, Capital Account, Loan Account etc.

They are two types of changes that may take place in an Account, e.g. either there will be increase or there will be decrease. Take the example of Cash (an asset), either there is inflow of cash or there is outflow of cash. To record these two types of changes, every account (a page) is divided into sides. Increase is recorded on one side and decrease is recorded on the other side. The specimen of an account (a 'T' form of an account) is shown bellow:

Dr. TITLE OF ACCOUNT	Cr.
Left side	**Right side**
OR	**OR**
Debit side	**Credit side**

When a change takes place in an account, either it will be recorded on the left side (Debit Side) or on the right side (credit side). Amounts recorded on the left side of an account, regardless of the account title, are called **debits**, and the account is said to be **debited.** Amounts recorded on the right side of an account are called **Credits**, and the account is said to be **credited.** Now keeping in mind the concept of double change in every business transaction, we can say that **every business transaction affects a minimum of two accounts and every change (in a particular transaction) is recorded in a separate account.** Now question arises, how the changes are recorded in different account? It depends upon the rules of debiting and crediting which have been discussed below:

IMPORTANT NOTES:

*All the accounts are kept in a register known as **'LEDGER'**. Recording business transctions in various acounts in ledger is in fact the 2nd phase of accounting cycle (the first phase is JOURNAL). But to have a better understanding of rules of debiting and crediting, the topic of accounts has been discussed in this chapter. The proper format of ledger accounts will be discussed in chapter No. 5.*

RULES FOR DEBITING AND CREDITING:

All the accounts maintained in the ledger of a business are classified into five;

(1) Accounts of Assets.

(2) Accounts of Liabilities.

(3) Accounts of Owner or Owner's Equity.

(4) Accounts of Expenses.

(5) Accounts of Revenues.

RULE FOR DEBITING OR CREDITING ACCOUNTS OF ASSETS: AN EXAMPLE:

(i) Increase in an asset is recorded on the left side or debit side of the account.

(ii) Decrease in a asset is recorded on the right side or credit side of the account.

In simple words, when there is increase in an asset, the amount is recorded on the debit side of that particular asset account and when there is decrease in an asset, the amount is recorded on the credit side of that particular asset account.

For example, furniture is purchased for Rs. 10,000 on cash basis. This is a business transaction and it has brought two changes:

(a) Increase in furniture by Rs. 10,000 (an asset).

(b) Decrease in cash by Rs. 10,000 (an asset).

These two changes are recorded in two accounts:- Furniture account and cash account in the following way:

Dr. Furniture Account Cr.

Dr.	Cr.
Rs.	
10,000	

Dr. Cash Account Cr.

Dr.	Cr.
	Rs.
	10,000

When an amount of Rs. 10,000 is recorded on the debit side of Furniture account, it is said that Furniture account is **debited** and when an amount of Rs. 10,000 is recorded on the credit side of cash account, it is said that cash account is **credited.**

The rule may be illustrated in the following way:

Dr. ASSETS ACCOUNT Cr.

Dr.	Cr.
(1) Debit side for Increase	Credit side for Decrease

The other rules for debiting and crediting the accounts are given below:

Dr. Liability Account Cr.

Dr.	Cr.
(2) Debit side for Decrease	Credit side for Increase

Dr. Expense Accounts Cr.

Dr.	Cr.
(3) Debit side for Increase,	Credit side for Decrease

Dr. Capital Account Cr.

Dr.	Cr.
(4) Debit side for Decrease	Credit side for Increase

Dr. Revenue Accounts Cr.

Dr.	Cr.
(5) Debit side for Decrease	Credit side for Increase

EXPLNATION OF THE RULES:

1. Rule regarding the debiting and crediting the accounts of assets has been explained earlier.

2. When a liability is created or increased by an amount, that amount is recorded on the credit side of the concerned liability account and when a liability is reduced or decreased, the amount is recorded on the debit side of that particular liability account. For example, if furniture is purchased for Rs. 5000 from Mr. Arif on credit basis, two changes will take place;

   (a) Furniture is increased by Rs. 5000 (an asset).

   (b) A liability (creditor Mr. Arif) in increased by Rs. 5000.

   The two changes are recorded in two accounts:

Dr. Furniture Account Cr.

Dr.	Cr.
Rs.	
5000	

Dr. Mr. Arif Account (a liability) Cr.

Dr.	Cr.
	Rs.
	5000

Suppose, after sometime cash is paid to Mr. Arif (a liability) amounting to Rs. 3000. Again, there are two changes;

(a) Cash is decreased by Rs. 3000 (an asset).

(b) Liability (creditor Mr. Arif) is decrreased by Rs. 3000.

The two changes are recorded in two accounts; on the debit side of Mr. Arif account (for decrease in liability Mr. Arif account is debited) and on the credit side of cash account (Being decrease in asset).

3. When an expenses is incurred (increased) by an amount, that amount is recorded on he debit side of that particular Expense account. For example, wages are paid in cash amounting to Rs. 9000. The two changes have taken place;

   (a) Wages incurred (increase in expense) by Rs. 9000.

   (b) Cash decreased (an asset) by Rs. 9000.

   These two changes are recorded in two accounts:

Dr. Wages Account (An Expense) Cr.

Dr.	Cr.
Rs.	
9000	

Dr. Expense Accounts Cr.

Dr.	Cr.
	Rs.
	9000

NOTE:

There are very rare examples of decrease in expenses. So, all expenses accounts are generally debited.

4. When Capital or Owner's Equity is increased (amount invested by the owner is increased) by an amount, that amount is recorded on the credit side of the capital account. For example, Mr. Ashraf (the owner) invested Rs. 100,000 in cash in his business. There are two changes:
   (a) Increase in capital or Owner's Equity (internal borrowing) by an amount of Rs. 100,000.
   (b) Increase in cash by an amount of Rs. 100.000 (an asset).

   These two changes are recorded in two accounts:

Dr. Capital or Owner's Equity A/c Cr.

	Rs.
	100,000

Dr. Cash Account Cr.

Rs.	
100,000	

5. When there is increase in the revenue (increase in sales, Discount received, commission received, interest received) of the business by an amount, that amount is recorded on the credit side of that particular revenue account. For example, goods worth Rs. 15000 are sold for cash. The two changes are:
   (a) Increase in sales (a revenue) by Rs. 15000.
   (b) Increase in cash (an asset) by Rs. 15000.

   These two changes are recorded in two accounts:

Dr. Sales Account (A revenue) Cr.

	Rs.
	15,000

Dr. Cash Account (An Asset) Cr.

Rs.	
15,000	

NOTE:

There are very rare examples, when revenue is decreased. So, all revenue accounts are generally credited.

STEPS TO REMEMBER FOR APPLICATION OF RULES:

1. See the number of changes which have taken place in a business transaction.
2. In which accounts those changes should be recorded?
3. Apply the rules for debiting and crediting according to the classifications of those accounts.

A COMPREHENSIVE ILLUSTRATION TO UNDERSTAND THE RULES:

TRANSACTION NO. 1

Mr. Zeeshan started his business by investing Rs. 100,000 cash.

ANALYSIS:

(a) This transaction has brought two changes.
   (i) Cash is increased by Rs. 100,000.
   (ii) Capital or Owner's Equity is increased by Rs. 100,000.

"	04	Cash Sales Rs. 8,000
"	13	Sold goods on account to Zeeshan Rs. 13,300
"	17	Received cash from Zeeshan Rs. 13,000; discount allowed Rs. 300
"	20	Paid Zahid & Co. against account Rs. 3,800; discount received Rs. 200
"	26	Gave away charity in the shape of goods Rs. 100
"	27	Goods taken away by the owner Rs. 350
"	28	Goods distributed as Free Samples Rs. 500
"	30	Paid salaries Rs. 1,000; Rent Rs. 700 and repairing charges for Rs. 500
"	30	Paid Shipping Freight Rs. 4,000; Forwarding charges Rs. 500; Telephone & Telex bills for Rs. 1,200 and Salaries Rs. 4,000
"	30	Received the followings:

Interest	Rs.	3,800
Commission		1,200

3. Record the following transactions in various accounts by applying the rules of debiting and crediting and make the totals of debit and credit amounts.

1. Mr. Khurshid started business with Rs. 20,000.
2. Bought Office Furniture from B on credit for Rs. 2,000.
3. Bought Office Equipment of Rs. 1,000.
4. Bought Goods worth Rs. 5,000 for cash from X.
5. Sold Goods to Y for Cash Rs. 2,500.
6. Bought Goods from B on credit for Rs. 1,500.
7. Sold Goods on credit to Ali for Rs. 555.
8. Paid X Rs. 3,000 on account.
9. Received from Ali Rs. 425 on account.
10. Received interest from Y Rs. 250.
11. Paid salaries Rs. 875.
12. Paid Rs. 500 into Bank from Office Cash.
13. Paid Office Rent, Rs. 450.
14. Paid for Office Stationery, Rs. 50.
15. Bought Office Stationery on credit from Alam & Co. Rs. 75.
16. Received Interest on Investments, Rs. 200.
17. Paid Electric charges, Rs. 55.

CHAPTER - 4

JOURNAL: THE ORIGINAL BOOK OF ENTRY

(c) Increase in cash is recorded on the debit side of cash account. Decrease in debtor is recorded on the credit side of Mr. Kashif account and discount allowed on the debit side of Discount allowed account.

Dr. Discount Allowed Account (an expense) Cr.

Dr.	Rs.	Cr.
(9)	100	

TRANSACTION NO. 10

Salaries Paid Rs. 5000.

ANALYSIS:

(a) The two changes are:

(i) Increase in an expense (salaries) by Rs. 5000.

(ii) Decrease in cash by Rs. 5000.

See rules for expense and asset accounts.

(b) The two accounts involved are:- Salaries account and Cash account.

(c) Increase in expense (salaries) is recorded on the debit side of Salaries Account and decrease in cash on the credit side of Cash account.

Dr. Salaries Account (an Expense) Cr.

Dr.	Rs.	Cr.
(10)	5000	

TRANSACTION NO. 11

Cash withdrawn from the business by the owner for his personal use Rs. 4500.

ANALYSIS:

(a) The two changes are:

(i) Decrease in capital or Owner's Equity (increase in drawings) by Rs. 4500.

(ii) Decrease in cash by Rs. 4500.

See the rules for capital and assets account.

(b) The two accounts involved are:- Drawings account (instead of capital account, decrease in capital is recorded in a separate account) and Cash account.

(c) Decrease in capital is recorded on the debit side of Drawings account and decrease in cash on the credit side of Cash account.

Dr. Drawings Account Cr.

Dr.	Rs.	Cr.
(11)	4500	

From the above illustration, it is very much clear that a business transaction may bring two changes or more than two changes in various accounts and every change is recorded in a separate account. It may also be noted that all the amounts recorded on the debit sides of different accounts are exactly equal to the amounts recorded on the credit sides of different accounts. ***Thus, regardless of the complexity of a transaction or the number of accounts affected, the sum of the debits is always equal to the sum of the credits. This Equality of debit and credit for each transaction is inherent in the accounting equation A = L + C. It is also because of this duality that the system is known as Double-Entry Accounting System.***

QUESTIONS

1. Explain the steps involved in the analysis of business transactions.
2. What do you mean by Double Entry System of book-keeping? How is it different from Single Entry System?
3. What are the advantages of the Double Entry System?
4. What is an Account? How accounts are classified?
5. Explain the rules of debit and credit with the help of examples.

PROBLEMS

1. **Analyse the following transactions:**

1992			Rs.
Feb.	01	Mohsin commenced business with cash	150,000
"	05	Purchased office furniture for cash	2,000
"	07	Purchased goods for cash	9,000
"	10	Paid carriage on purchases	250
"	12	Purchased goods from Salim & Co.	7,000
"	13	Sold goods for cash	12,000
"	15	Sold goods to Usman & Sons.	15,000
"	21	Received cash from Usman & Sons.	13,000
"	21	Paid cash to Salim & Co.	3,000
"	29	Paid Salaries for the month	2,500

2. **Make the analysis of the following transactions and record then in various accounts.**

1990		
June	01	Invested Rs. 100,000 cash; Building Rs. 75,000 and Furniture Rs. 25,000
"	02	Purchased goods for cash Rs. 44,000 subject to trade discount @ 5 %.
"	03	Purchased goods from Zahid & Co. for Rs. 4,000

See the rules for assets, liability and revenue accounts.

(b) These three changes are recorded in three accounts, Cash Account. Mr. Aslam Account and Discount Received Account.

(c) Decrease in cash is recorded on the credit side of cash account, decrease in liability on the debit side of Mr. Aslam account with an amount of Rs. 14500 and increase in discount received on the credit side of Discount received account, being increase in revenue.

(A Revenue A/c)

Dr. Discount Received Account Cr.

			Rs.
		(2)	200

NOTE:

Cash is paid to the creditor, Mr. Aslam Rs. 14300 and a discount of Rs. 200 is received from him as payment is made to him before due date.

TRANSACTION NO. 6

Goods are sold for cash Rs. 9000.

ANALYSIS:

(a) The two changes are;

(i) Increase in cash by Rs. 9000.

(ii) Increase in sales by Rs. 9000 (a revenue).

See rules for Asset and Revenue accounts.

(b) These two changes are recorded in two accounts: Cash account and Sales account.

(c) Increase in cash is recorded on the debit side of cash account and increase in sales on the credit side of sales account.

Dr. Sales Account (a revenue) Cr.

			Rs.
		(6)	9000
		(7)	4000

TRANSACTION NO. 7

Goods are sold to Mr. Kashif for Rs. 4000 on credit basis.

ANALYSIS:

(a) There are two changes;

(i) Increase in debtor Mr. Kashif (an asset) by Rs. 4000.

(ii) Increase in Sales (a revenue) by Rs. 4000.

See rules for asset and revenue accounts.

(b) These two changes are recorded in two accounts:- Mr. Kashif Account and Sales Account.

(c) Increase in debtor (an asset) is recorded on the debit side of Mr. Kashif account and increase in sales on the credit side of Sales account.

Dr. Mr. Kashif Account (an asset) Cr.

	Rs.		Rs.
(7)	4000	(8)	300
		(9)	3700

TRANSACTION NO. 8

Goods returned by Mr. Kashif worth Rs. 300.

ANALYSIS:

(a) The two changes are:

(i) Decrease in sales or increase in Sales Returns (a decrease in revenue) by Rs. 300.

(ii) Decrease in Debtor Mr. Kashif (amount receivable from him) by Rs. 300.

See the Rule for assets and revenue accounts.

(b) These two changes are recorded in two accounts:- Sales Returns account and Mr. Kashif account.

(c) Increase in sales returns is recorded on the debit side of Sales Returns account (assuming decrease in sales recorded in a separate account instead of sales account) and decrease in debtor on the credit side of Mr. Kashif account.

Dr. Sales Returns Account Cr.

	Rs.		
(8)	300		

TRANSACTION NO. 9

Cash received from Mr. Kashif Rs. 3600 in full satisfaction of the claim of Rs. 3700 (assuming cash is received from him before due date).

ANALYSIS:

(a) There are three changes:

See rules for asset and revenue accounts.

(i) Cash is increased by Rs. 3600.

(ii) Debtor (Mr. Kashif) is decreased by Rs. 3700.

(iii) Discount allowed Rs. 100 (an expense).

(b) These three changes are recorded in three accounts:- Cash account, Mr. Kashif account and Discount allowed account.

(b) These two changes are recorded in two accounts, Cash Account and Capital Account.

(c) Increase in cash (an asset) is recorded on the debit side, increase in capital is recorded on the credit side:

See the rules for Assets & Capital Account

Dr. Cash Account Cr.

	Rs.		Rs.
(1)	100000	(2)	10000
(6)	9000	(5)	14300
(9)	3600	(10)	5000
		(11)	4500

Dr. Capital Account Cr.

			Rs.
		(1)	100000

TRANSACTION NO. 2

He purchased furniture for Rs. 10,000 and paid cash.

ANALYSIS:

(a) The two changes are:

(i) Furniture is increased by Rs. 10,000.

(ii) Cash is decreased by Rs. 10,000.

(b) These two changes are recorded in two accounts; Furniture Account and Cash Account.

See the rule for Assets Accounts.

(c) Increase in furniture is recorded on the debit side of furniture acount and decrease in cash is recorded on the credit side of cash account.

Dr. Furniture Account Cr.

	Rs.		
(2)	10,000		

TRANSACTION NO. 3

Goods are purchased from Mr. Aslam for Rs. 15000 on credit basis.

ANALYSIS:

(a) The two changes are:

(i) Goods (purchases) increased by Rs. 15000 (an expense).

(ii) A creditor, Mr. Aslam is created by Rs. 15000 (a liability).

See the rules for Expenses and liability accounts.

(b) These two changes are recorded in two accounts:- Purchases Account and Mr. Aslam Account (a liability).

(c) Increase in goods is recorded on the debit side of Purchases account and increase in liability on the credit side of Mr. Aslam account

Purchases Account (an Expense)

Dr.	Rs.		Dr.
(3)	15000		

Mr. Aslam Account (a Liability)

Dr.	Rs.		Cr. Rs.
(4)	500	(3)	15000
(5)	14500		

TRANSACTION NO. 4

Goods returned to Mr. Aslam worth Rs. 500, being defective.

ANALYSIS:

(a) The two changes are;

See the rule for Liability and Expense accounts

(i) Decrease in goods or increase in purchases returns of the business (decrease in Expense) by Rs. 500.

(ii) Decrease in liability (amount payable to Mr. Aslam) by Rs. 500.

(b) These two changes are recorded in two accounts:- Purchases Returns Account and Mr. Aslam Account.

(c) Increase in purchases returns is recorded on the credit side of Purchases Returns Account and decrease in libility on the debit side of Mr. Aslam Account.

Purchases Returns Account (Decrease in Expense)

Dr.			Cr. Rs.
		(4)	500

NOTE:

Goods returned are not recorded on the credit side of purchases account, instead are recorded in a separate account named "Purchases Returns Account".

TRANSACTION NO. 5

Cash paid to Mr. Aslam Rs. 14300 in full satisfaction of his claim of Rs. 14500 (Assume cash is paid to him before due date).

ANALYSIS:

(a) There are three changes;

(i) Decrease in cash by Rs. 14300.

(ii) Decrease in liability (amount payable to Mr. Aslam) by Rs. 14500.

(iii) Increase in Discount received by Rs. 200 (a revenue).

JOURNAL: THE ORIGINAL BOOK OF ENTRY

JOURNAL: 1ST PHASE OF ACCOUNTING CYCLE

In the previous chapter, we have discussed in detail that how the business transactions are analysed and how different accounts are debited and credited. Now, we are in a good portion to record various business transactions in proper books of accounts. According to Double Entry System transactions are recorded in the books of accounts in two stages:

First Stage — *Journal*
Second Stage — *Ledger*

The flow of accounting information from the time a transaction takes place to its recording in the ledger may be illustrated as follows:

Business TRANSACTION occurs ⟶ Business DOCUMENT Prepared ⟶ Entry recorded in JOURNAL ⟶ Entry posted to LEDGER

NOTE:

The initial record of each transaction is evidenced by a business document such as invoice, cash voucher etc.

Transactions are first recorded in Journal and thereafter posted to the two or three concerned accounts in the Ledger. Ledger has been discussed in details in the next Chapter.

DEFINITION:

The word "Journal" has been derived from the French word "Jour". Jour means day. So, Journal means daily. Transactions are recorded daily in Journal and hence it has been named so. As soon as a transaction takes place its debit and credit aspects are analysed and first of all recorded chronologically in a book together with its short description. This book is known as **Journal**. Thus we see that the most important function of Journal is to show the relationship between the two accounts connected with a transaction. This facilitates writing of Ledger. **Walter Grierson** has rightly described the book as "simply assistant of Ledger". Since transactions are first of all recorded in Journal, so it is called **Book of Original Entry or Prime Entry or Primary Entry or Preliminary Entry or First Entry.**

ENTRY:

Recording a transaction in the appropriate place of the concerned book of account is called **Entry**. Entry may be divided into two:

JOURNAL ENTRY:

Recording a transaction in a Journal is called **Journal Entry** or **Journalising.**

LEDGER ENTRY:

Recording a transaction from Journal to the concerned account in Ledger is called **Ledger Entry.** It is also known as **Ledger posting.**

NARRATION:

A short explanation of each transaction is written under each entry which is called **Narration.** The subject matter of the transaction can be ascertained through narration. Besides this, if there be any mistake in determining debit or credit aspect of a transaction, it can be easily detected from narration. "A Journal entry is not complete without narration".

CHARACTERISTICS:

Journal has the following features:

(1) Journal is the first successful step of the Double Entry system. A transaction is recorded first of all in the Journal. So, Journal is called the book of **Original Entry.**

(2) A transaction is recorded on the same day it takes place. So, Journal is also called a **Day Book.**

(3) Transactions are recorded chronologically. So, Journal is called **Chronological Book.**

(4) For each transaction the names of the two concerned accounts indicating which is debited and which is credited, are clearly written in two consecutive lines. This makes ledger-posting easy. That is why Journal is called **"Assistant to Ledger"** or **"Subsidiary Book".**

(5) Narration is written below each entry.

(6) The amount is written in the last two columns - debit amount in Debit column and credit amount in Credit column.

ADVANTAGES:

The following are the advantages of Journal:

(1) Each transaction is recorded as soon as it takes place. So there is no possibility of any transaction being omitted from the books of account.

(2) Since the transactions are kept recorded in Journal chronologically with narration, it can be easily ascertained when and why a transaction has taken place.

(3) For each and every transaction which of the two concerned accounts will be debited and which account credited, are clearly written in Journal. So, there is no possibility of committing any mistake in writing the Ledger.

(4) Since all the details of transactions are recorded in Journal, it is not necessary to repeat them in Ledger. As a result Ledger is kept tidy and brief.

(5) Journal shows the complete story of a transaction in one entry.

(6) Any mistake in Ledger can be easily detected with the help of Journal.

FORMAT OF THE JOURNAL

Date	Details	L/F	Amount Rs.	Amount Rs.
	Account to be debited.................................... Dr.		x x x	
	Account to be credited			x x x
	(Narration)			

RULES FOR JOURNALISING

How a transaction is recorded in Journal, is discussed below: Suppose the transaction is —

Purchased furniture from M. Asif on 10.1.91 for Rs. 8000.

Here Furniture A/c is debited and M. Asif A/c is credited.

JOURNAL **Dr.** **Cr.**

Date	Details	L/F	Amount Rs.	Amount Rs.
1991 Jan. 10	Furniture A/c .... Dr.		8,000	
	M. Asif A/c			8,000
	(Being cost of furniture purchased)			

Now the various columns of Journal are explained in details below:

1. DATE:

The date of transaction is written in this column in two lines - in the first line, the year and in the second line, first the name of month and thereafter the actual date.

2. DETAILS:

In this column the names of the two connected accounts are written in two consecutive lines – in the first line the name of Account debited and in the second line the name of Account credited. While the name of Account debited always placed close to the left-hand margin line, the name of Account credited is commenced a short distance away from the margin line. This arrangement will show clearly which account is debited and which credited. This also shows that Credit Amount is placed on the right side of Debit Amount. The word "Dr" is used at the end of the name of Account debited. It is not necessary to place the word "Cr" after the name of Credited Account, because if one account is Dr. it follows that the other account must be Cr. Below the names of the two Accounts, i.e. in the third line **Narration** is written usually within a bracket. According to tradition, narration is written starting with the word "Being". But modern practice is not to use this word.

NOTE:

In most of the countries, (even in Great Britain) using the word "TO" at the beginning of the name of account credited has become out-dated. So, in this book it has not been used. But it is optional for the students.

3. L.F. (LEDGER FOLIO):

The page numbers of the Ledger where the two concerned accounts have been posted, are written in this column against the name of each account. This will help locating easily the two concerned accounts from the Ledger. On the other hand, when a transaction is posted to Ledger, the concerned folio number of the Ledger is written is this column. Thus if a folio number stands written in this column, it will mean that the transaction has already been posted to Ledger.

4. AMOUNT:

The debit amount is written in the first "Amount" column against the name of Account debited and the credit amount in the second "Amount" column against the name of Account credited.

NOTE:

Although the above form of Journal is used in examination answer book, it is not fully correct. Because in large concerns Journal is divided into eight subdivisions for the sake of convenience. Out of them only in one subdivision (i.e. Journal Proper) the above form is used. In the remaining seven subdivisions the form of Journal is different.

SIMPLE ENTRY & COMPOUND ENTRY

Every transaction affects two accounts – one account is debited and another account is credited. Thus in recording a transaction in a Journal one account is debited and another account is credited. This type of entry is called **Simple Entry.** For example, on 10.4.91 we bought furniture for Rs. 5000 from Salman Bros. The entry is:

JOURNAL **Dr.** **Cr.**

Date	Details	L.F.	Amount Rs.	Amount Rs.
1991				
Apr. 10	Furniture A/c .... Dr.		5,000	
	Salman Bros. A/c			5,000
	(Being furniture bought on credit)			

The entry in which more than one account is debited or more than one account is credited, is known as **Compound Entry.** Three or more accounts are connected with compound entry. For example suppose, on 16.5.91 we paid Rs. 500 on account of salaries and Rs. 300 on account of rent. For this the entry will be:

JOURNAL

Date	Details	L.F.	Dr. Amount Rs.	Cr. Amount Rs.
1991				
May 16	Salaries A/c ....Dr.		500	
	Rent A/c.. Dr.		300	
	Cash A/c			800
	(Being salaries and rent paid)			

Here two accounts have been debited and the entry involves three accounts. Hence, it is a compound entry.

In this connection, it may be noted that the **business and its proprietor are different and separate.** So transactions relating to business are to be recorded in the books of business, while the private transactions of the proprietor of business are to be recorded in the personal books of the proprietor. **No private transactions of the proprietor can be recorded in the books of business. On the other hand, no transactions of the business can be recorded in the books of its proprietor. But transaction in between the business and its proprietor must be recorded in the books of both the proprietor and his business.** If these rules are not strictly followed, the books of account will fail to disclose the true result of business.

NOTE:

We are concerned with the books of business, not with the private books of proprietor.

Transactions between the business and its proprietor are recorded in the following two accounts:

1. CAPITAL ACCOUNT:

The money with which proprietor starts his business, is called capital. When proprietor brings capital in the business, it is recorded in Capital A/c. Capital A/c is in fact the personal account of the proprietor. So, it is a Personal Account. The proprietor has given benefit to the business through introduction of capital. So Proprietor's A/c, i.e. Capital A/c will be credited. From the viewpoint of book-keeping the introduction of capital to the business by proprietor means that the proprietor lends the money to his business and the business becomes indebted to him. The proprietor is regarded as a special or internal creditor to the business.

EXAMPLE:

M. Rashid started a business with Rs. 10,000.

Date	Details	L.F.	Dr. Amount Rs.	Cr. Amount Rs.
	Cash A/c ....Dr.			
	Capital A/c		10,000	
	(Being capital brought in)			10,000

2. DRAWINGS ACCOUNT:

If the proprietor draws any money or goods from his business for his personal use, it will be recorded in Drawings A/c. Drawings A/c is the personal account of the proprietor, so it is classified as Personal Account. Proprietor receives benefit, when he withdraws money or goods from business. So the Proprietor's A/c. i.e. Drawings A/c is debited.

EXAMPLE:

Date	Details	L.F.	Dr. Amount Rs.	Cr. Amount Rs.
	Drawings A/c .... Dr.		1,000	
	Cash A/c			1,000
	(Being amount withdrawn by proprietor)			

CASH DISCOUNT

The manufacturers and whole sellers frequently grant a cash discount to their debtors who will pay their debts before due date for goods purchased by them on credit. The seller regards it a 'Cash discount' or 'Sales discount, or discount allowed', the buyer calls the discount as 'Purchase discount' or 'discount received'. The use of sales discounts not only stimulate prompt collection but also tend to reduce the possibilities of losses resulting from 'Bad Debts'.

The type and amount of Cash discounts depend upon the 'CREDIT TERMS' settled mutually at the time of bargaining.

The terms have been discussed below:

	Types of Terms	*Explanation*
1.	2/10, n/30	A discount of 2 % is allowed, if payment is made within 10 days from the date of sale. The term of credit allowed is 30 days.
2.	1/15, n/30	A discount of 1 % is allowed, if the payment is made within 15 days from the date of sale of goods. The term of credit allowed is 30 days.

GOODS TAKEN BY THE OWNER FOR PERSONAL USE:

Sometimes goods are taken away by the owner from the business for his personal or family use. Undoubtedly, goods are going out of the business but not sold. So, sales account should not be credited, instead Purchases Account should be credited because this is reduction in the goods purchased.

GOODS GIVEN AWAY AS CHARITY, FREE SAMPLES OR GOODS LOST:

When goods are given away as charity or free samples, this is not sale of goods, so not credited to sales account. Similarly, when goods are lost by fire or by theft or an accident, purchases account should be given the credit.

ILLUSTRATION NO. 1 SL

Journalise the following transactions:

Following steps should be kept in mind before journalising the transactions:

(1) Which are the two aspects of each transaction?

(2) Which accounts are concerned?

(3) Concerned accounts belong to which category?

(4) Which rule of 'debit and credit' is applicable?

			Rs.
1992			
Feb.	**3**	**X commenced business with a capital of**	**5,000**
	5	**Purchased goods**	**2,000**
	7	**Purchased goods on credit from Sarwar & Co.**	**1,000**
	10	**Purchased furniture**	**800**
	11	**Sold goods**	**1,300**
	15	**Sold goods on credit to Dilawar Bros.**	**750**
	20	**Paid salaries**	**320**
	25	**Received commission**	**25**
	26	**Returned goods to Sarwar & Co.**	**200**
	27	**Returned goods by Dilawar Bros.**	**150**
	28	**Received from Dilawar Bros.**	**500**
		Paid to Sarwar & Co.	**600**
		X withdrew from business	**300**
		Charged depreciation on furniture	**80**
		Borrowed from Shafiq	**500**

Solution:

JOURNAL

Date	Details	L.F.	Dr. Amount Rs.	Cr. Amount Rs.
1992				
Feb. 3	Cash A/c ... Dr.		5,000	
	Capital A/c			5,000
	(Being capital brought in)			
5	Purchases A/c ... Dr.		2,000	
	Cash A/c			2,000
	(Being goods purchased for cash)			
7	Purchases A/c ... Dr.		1,000	
	Sarwar & Co. A/c			1,000
	(Being goods purchased on credit from Sarwar & Co.)			

10	Furniture A/c ... Dr. Cash A/c (Being furniture bought for cash)	800	800
11	Cash A/c ... Dr. Sales A/c (Being goods sold for cash)	1,300	1,300
15	Dilawar Bros. A/c ... Dr. Sales A/c (Being goods sold on credit to Dilawar Bros.)	750	750
20	Salaries A/c ... Dr. Cash A/c (Being salaries paid)	320	320
25	Cash A/c ... Dr. Commission A/c (Being commission received)	25	25
26	Sarwar & Co. A/c ... Dr. Purchases A/c Return (Being goods returned to Sarwar & Co.)	200	200
27	Sales Returns A/c ... Dr. Dilawar Bros. A/c (Being goods returned by Dilawar Bros.)	150	150
28	Cash A/c ... Dr. Dilawar Bros. A/c (Being amount received from Dilawar Bros.)	500	500
"	Sarwar & Co. A/c ... Dr. Cash A/c (Being amount paid to Sarwar & Co.)	600	600
"	Drawings A/c ... Dr. Cash A/c (Being amount withdrawn by proprietor)	300	

"	Depreciation A/c ... Dr.		80	
	Furniture A/c			80
	(Being depreciation charged on furniture)			
"	Cash A/c ... Dr.		500	
	Shafiq A/c			500
	(Being amount borrowed from Shafiq)			

NOTE:

In writing the name of a personal account (debtor or creditor) in the general entry, it is optional for the students to add the word "Account" after the name of the person.

ILLUSTRATION NO. 2 SL

Amir started business on 1st January 1991 with Rs. 20,000 as capital. Below mentioned are the transactions which took place in the month of January. He requests you to enter these in his Journal.

Jan. 91

2	**Opened Bank Account with Rs. 15,000.**
3	**Goods are purchased from Rehman on credit for Rs. 7,000.**
7	**Purchased second hand duplicating machine for cash for Rs. 2,000.**
7	**Sold goods on credit to Munir worth Rs. 1,500.**
8	**Purchased goods on cash for Rs. 1,000.**
9	**Cash sales to Farooq worth Rs. 1,000.**
10	**Machinery purchased payment made by cheque Rs. 6700.**
12	**Borrowed Rs. 3,000 from Tufail.**
18	**Fire occurred in the business and goods worth Rs. 700 were destroyed.**
30	**Paid rent to Waris Rs. 100 for the building in which business is situated.**
31	**Paid salary to clerk Rs. 150.**
31	**Received Rs. 1,450 from Munir in full settlement of his account.**
31	**Paid Rs. 3,000 to Rehman in part-payment of the amount due to him.**
31	**Amir withdrew Rs. 500 for his personal use.**
31	**Bank credited his account for interest Rs. 50.**

Solution:

JOURNAL

Date	Details	L.F.	Dr. Amount Rs.	Cr. Amount Rs.
1991				
Jan. 1	Cash account Dr.		20,000	
	Amir's Capital Account			20,000
	(Started business with Rs. 20,000)			
2	Bank Account Dr.		15,000	
	Cash Account			15,000
	(Opened Bank A/c and deposited cash Rs. 15,000)			
3	Purchases Account Dr.		7,000	
	Rehman account			7,000
	(For credit purchases from Rehman vide Invoice No...)			
7	Office Equipment Account Dr.		2,000	
	Cash Account			2,000
	(For the purchases of second hand duplicating machine)			
7	Munir Account Dr.		1,500	
	Sales Account			1,500
	(For credit sales to Munir vide Outward Invoice No....)			
8	Purchases Account Dr.		1,000	
	Cash Account			1,000
	(For cash purchases vide Cash Memo No.......)			
9	Cash Account Dr.		1,000	
	Sales Account			1,000
	(For cash sales vide receipt No.....)			
10	Machinery Account Dr.		6,700	
	Bank Account			6,700
	(For purchase of machinery)			
12	Cash Account Dr.		3,000	
	Tufail's Loan Account			3,000
	(For the amount borrowed from Purchases)			

18	Loss by Fire Account Dr.		700	
	Purchases Account			700
	(For the goods destroyed by fire)			
30	Rent Account Dr.		100	
	Cash Account			100
	(Payment of rent for the month of ....)			
31	Salaries Account Dr.		150	
	Cash Account			150
	(Payment of salary to clerk)			
31	Cash Account Dr.		1450	
	Discount Account Dr.		50	
	Munir Account			1,500
	(For the amount received and discount allowed vide receipt No.......)			
31	Rehman Account Dr.		3,000	
	Cash Account			3,000
	(For the payment on account' vide receipt No........)			
31	Drawings Account Dr.		500	
	Cash Account			500
	(For the amount withdrawn by proprietor for personal use)			
31	Bank Account Dr.		50	
	Interest Account			50
	(For recording the interest income on Bank deposit)			

NOTE:

In actual practice, at the end of each page of journal total is struck and **carried forward** (c/f) to the next page where it is written in the beginning as **brought forward** (b/f).

ILLUSTRATION NO. 3 5L.

Journalise the following transactions in the books of Mr. Adnan.

1995			Rs.
Jan.	1	Commenced business with cash	30,000
	2	Deposited in the bank	8,000
	2	Purchased goods from Babar	10,000
	5	Purchased furniture from Saleem Furnishers	2,500
	6	Cash sales	9,000
	8	Cash purchases	10,000
	10	Sold goods to Hafeez	12,000
	13	Hafeez returned goods	2,000
	15	Paid cash to Babar	9,500
		Babar allows cash discount	500
	25	Mr. Adnan withdrew cash for personal use	1,500
	"	Goods drawn for personal use	800
	27	Gave away as charity cash	101
		and goods	101
	28	Sold goods to Hanif at list price less trade discount 10 %; cash discount 5 %.	8,000
	29	Hanif makes the payment of 80 % of the amount due availing the proportionate cash discount	
	30	Paid telephone bill	450
	31	Paid salaries of the office staff	1,200

Solution:

JOURNAL

Date	Details		L.F.	Dr. Amount Rs.	Cr. Amount Rs.
1995					
Jan. 1	Cash Account	Dr.		30,000	
	Adnan's Capital Account				30,000
	(Being the capital introduced by the owner in cash)				
Jan. 2	Bank Account	Dr.		8,000	
	Cash Account				8,000
	(Being the cash deposited in the bank)				

Jan. 2	Purchases Account Dr.	10,000	
	Babar Account		10,000
	(Being the goods purchased on credit)		
Jan. 5	Furniture Account Dr.	2,500	
	Saleem Furnishers Account		2,500
	(Being the purchase of office furniture)		
Jan. 6	Cash Account Dr.	9,000	
	Sales Account		9,000
	(Being the sales of goods for cash)		
Jan. 8	Purchases Account Dr.	10,000	
	Cash Account		10,000
	(Being the purchases of goods on cash)		
Jan. 10	Hafeez Account Dr.	12,000	
	Sales Account		12,000
	(Being the sale of goods on credit)		
Jan. 13	Returns Inwards Account Dr.	2,000	
	Hafeez Account		2,000
	(Being the goods returned by the customer)		
Jan. 15	Babar Account Dr.	10,000	
	Cash Account		9,500
	Discount Account		500
	(Being the payment of cash and availing of cash discount)		
Jan. 25	Drawings Account Dr.	2,300	
	Cash Account		1,500
	Purchase Account		800
	(Being the cash and goods withdrawn by Proprietor)		
Jan. 27	Charity Account Dr.	202	
	Cash Account		101
	Purchases Account		101
	(Being the cash and goods given as charity)		

Jan. 28	Hanif Account Dr. Sales Account (Being sales at lost price 8,000 less 10 % trade discount)		7,200	7,200
Jan. 29	Cash Account Dr. Discount Account Dr. Hanif Account (Being the receipt of 80 per cent of the amount due $\left[7{,}200 \times \frac{80}{100} = 5{,}760\right]$ after allowing 5 per cent cash discount $\left[5760 \times \frac{5}{100} = 288\right]$		5,472 288	5,760
Jan. 30	Telephone Expenses Dr. Cash Account (Being the payment of telephone bill No.......)		450	450
Jan. 31	Salaries Account Dr. Cash Account (Being the payment of office salaries)		1,200	1,200

ILLUSTRATION NO. 4 SL

Journalise the following transactions in the books of Mr. Asad for the month of January 1992.

Jan. 1. Mr. Asad no capital of his own, started business with Rs. 10,000 borrowed from his friend Riaz @ 12 per cent p.a.

2. Purchased goods worth Rs. 6,000, less 20 % trade discount from Mohsin & Co., for cash and supplied them to Riaz at list price less 10 %.

4. Goods worth Rs. 200 were damaged in transit a claim was made on the railway authorities for the same.

10. Under instructions from Mohsin & Co., Mr. Asad supplied goods listed at Rs. 1,000 to Salman. Received the invoice at 20 % trade discount from Mohsin & Co.

13. Received cash from the railway in full settlement of claim for damages in transit.

18. **Salman is declared insolvent and a dividend of 50 paise in the rupee in received from him in full settlement.**

20. **Bought a cycle for Rs. 1800 for delivering goods to customers.**

24. **Bought goods worth Rs. 700 from Zaheer and supplied them to Kabir at Rs. 1,000.**

29. **Kabir returned goods worth Rs. 50, which in turn was sent to Zaheer.**

30. **One month's interest to Riaz on capital supplied by him became due, but could not be paid.**

31. **The cycle bought on January 20 was sold for Rs. 600 being damaged.**

Solution:

X'S JOURNAL

Date	Details	L.F.	Dr. Amount Rs.	Cr. Amount Rs.
1992				
Jan. 1	Cash Account Dr.		10,000	
	Riaz's Loan Account			10,000
	(Being the amount borrowed for starting business @ 12 percent per annum)			
Jan. 2	Purchases Account Dr.		4,800	
	Cash Account			4,800
	(Being the purchase $\left[(6,000) - \left(6,000 \times \frac{20}{100}\right)\right]$ = Rs. 4800)			
Jan. 2	Riaz Account Dr.		5,400	
	Sales Account			5,400
	(Being the sales at 10 % less than list price i.e. $\left[6,000 - \left(6,000 \times \frac{10}{100}\right)\right]$ = Rs. 5,400			
Jan. 4	Railway Claim Account Dr.		200	
	Purchases Account			200
	(Being the claim made on railways for goods damaged in transit)			

Jan. 10	Purchases Account Dr.		800	
	Mohsin & Co. Account			800
	(Being the purchase at 20 % less than list price)			
Jan. 10	Salman Account Dr.		1,000	
	Sales Account			1,000
	(Being the sales to Salman)			
Jan. 13	Cash Account Dr.		200	
	Railway Claim Account			200
	(Being the receipt of claim from railways)			
Jan. 18	Cash Account Dr.		500	
	Bad Debts Account Dr.		500	
	Salman Account			1,000
	(Being cash received and bad debt written off due to Salman insolvency)			
Jan. 20	Cycle Account Dr.		1,800	
	Cash Account			1,800
	(Being the purchase of cycle for use of sales delivery)			
Jan. 24	Purchases Account Dr.		700	
	Zaheer Account			700
	(Being purchases on credit from Zaheer			
Jan. 24	Kabir Account Dr.		1,000	
	Sales Account			1,000
	(Being credit sales to Kabir)			
Jan. 29	Returns Inwards Account Dr.		50	
	Kabir Account			50
	(Being goods returned by Kabir)			

Jan. 29	Zaheer Account Dr.		35	
	Returns Outwards Account			35
	(Being returns to Zaheer $\left(\frac{700}{1000} \times 50\right)$ = Rs. 35)			
Jan. 30	Interest Account Dr.		100	
	Riaz's Loan Account			100
	[Being interest becoming due $10,000 \times \frac{1}{12} \times \frac{12}{100}$]			
Jan. 31	Cash Account Dr.		600	
	Profit & Loss Account Dr.		1200	
	Cycle Account			1800
	(Being loss on the sale of damaged cycle transferred to P & L A/c and receipt of sale proceeds.)			

OBJECTIVE TYPE QUESTIONS

1. Following accounts are being maintained in the books of X. Classify these under, Assets, Liabilities, Capital, Expenses and Revenue headings:

(a) Interest (Cr.)
(b) Cash
(c) Bank
(d) Commission (Dr.)
(e) Rent
(f) Discount (Cr.)
(g) Land & Building
(h) Depreciation
(i) Drawing
(j) A's Loan A/c (Cr.)
(k) Furniture & Fittings A/c
(l) Capital
(m) Stock
(n) Motor Vehicles
(o) Bad Debts
(p) Goodwill
(q) Wages outstanding

2. What kinds of accounts are the following:

(i) Capital account
(ii) Drawings account
(iii) Purchases account
(iv) Bank account
(v) Sales returns account
(vi) Motor Vehicles account
(vii) Commission account
(viii) Wages account
(ix) Charity account
(x) Machinery account
(xi) Donation account
(xii) Furniture account
(xiii) Salaries account
(xiv) Purchases returns account

3. In each of the following cases indicate the alternative which you consider to be correct:

(a) A payment of Rupees One hundred to Azad Transporters for bringing a machine to our factory should be debited to:

(i) Azad Transporters, (ii) Carriage Inward A/c, (iii) Machine A/c, (iv) Cash A/c

(b) Goods of the value of Rs. 100, withdrawn by the owner for his private use should be credited to:

(i) Sales Account, (ii) Owner's Drawings A/c, (iii) Purchases A/c, (iv) Expenses A/c

(c) Wages of workmen employed for setting up new machinery should be debited to:

(i) Expenses A/c, (ii) Wages A/c, (iii) machinery A/c, (iv) Cash A/c

(d) Sales of goods to X from cash should be debited to:

(i) X, (ii) Cash, (iii) Sales.

(e) Loss of goods by fire should be credited to:

(i) Purchases A/c, (ii) Loss of Goods by fire A/c, (iii) Sales A/c

(f) Payment of Rs. 50 to Rahim as wages for repairing furniture (purchased) second hand should be debited to:

(i) Furniture A/c, (ii) Repairs A/c, (iii) Wages A/c, (iv) Rahim's A/c

(g) Rs. 500 received from Mohsin whose account was previously written of as bad debt should be credited to:

(i) Mohsin's account, (ii) Bad debts account, (iii) Bad debts recovered account

(h) A purchase of furniture for cash should be debited to:

(i) Cash account, (ii) Furniture account, (iii) Purchases account

(i) A withdrawal of cash from the business by the proprietor should be credited to:

(i) Capital account, (ii) Drawings account, (iii) Cash account

(j) Goods of the value of Rs 101 are given away as charity: this amount should be debited to:

(i) Charity account, (ii) Sales account, (iii) Purchases account

(k) Furniture purchased for private use of a partner should be debited to:

(i) Furniture account, (ii) Partner's Capital Account, (iii) Purchases account

Ans: *[(a) (iii); (b) (iii); (c) (iii); (d) (ii); (e) (i); (f) (i); (g) (iii); (h) (ii); (i) (iii); (j) (i); (k) (ii)]*

4. Tick (✓) the correct answer:

(i) Debit signifies:

(a) Increase in asset account
(b) Decrease in liability account
(c) Decrease in capital account
(d) None of these
(e) All of these.

(ii) Credit signifies:

(a) Increase in assets accounts
(b) Increase in liabilities accounts
(c) Decrease in Capital accounts
(d) None of these
(e) All of these.

(iii) Left side of asset account is for

(a) Recording decreases
(b) Recording increases
(c) Recording decreases and increases
(d) Recording the correction of errors

(iv) Right side of asset account is for
 (a) Recording decreases
 (b) Recording increases
 (c) Recording decreases and increases
 (d) Recording the rectifications

(v) A business transaction affects
 (a) At least one account
 (b) At least two accounts
 (c) Maximum of two accounts
 (d) Maximum of three accounts

Ans: *[(i) (e); (ii) (b); (iii) (b); (iv) (a); (v) (b)]*

QUESTIONS

1. What do you understand by Journal? How is it written up?
2. What are the characteristics of Journal?
3. What is Compound Entry? Explain with at least five examples.
4. Differentiate between Journal & Journalising?
5. What are the advantages of Journal?

PROBLEMS

1. **1992** SL.

March	01	Shakeel started business with cash Rs. 50,000
"	05	Purchased goods for cash for Rs. 10,000.
"	06	Purchased goods on account Rs. 5,000 from Ali.
"	10	Purchased Furniture for cash Rs. 4,000.
"	12	Sold goods for cash Rs. 12,000.
"	14	Sold goods on account Rs. 6,000 to Aslam.
"	25	Ali account settled receiving Rs. 150/- as discount.
"	26	Aslam account settled allowing Rs. 200/- as discount.

Required:

Record the above transactions in the Journal.

2. SL On 1st August, 1992 Mr. Furqan established a new business. The transactions for the month were as follows:

August:	01	Introduced cash as capital Rs. 148000.
"	01	Bought Furniture for Rs. 30000.
"	03	Cash purchases for Rs. 36000.
"	04	Purchased goods on account from Noor Mills Ltd., terms 2/10 - n/ 30 for Rs. 7,500.
"	09	Goods returned to Noor Mills Ltd., for Rs. 500.
"	12	Cash sales for Rs. 9,900.
"	17	Paid cash, less discount, to Noor Mills Ltd., in full settlement of account.
"	20	Sold goods to Mobeen & Co., terms 2/10 - n/30 for Rs. 2,500.
"	22	Loss by accident while goods were in transit Rs. 175.
"	23	Goods returned by Mobeen & Co., for Rs. 125.
"	24	Paid Tuition fees of Owner children for Rs. 200 and goods given as charity on his behalf for Rs. 100.
"	25	Received cash, less discount, from Mobeen & Co., in full settlement of account.
"	27	Sold furniture for Rs. 1,800.
"	30	Paid the following expenses: Salaries Rs. 2,000; Wages Rs. 1,000; Electricity Rs. 110; Bank charges Rs. 140 and Insurance premium Rs. 330

Required: Journalise the above transactions.

3. SL Journalise the following transactions in the books of a trader:

1984		Rs.
Dec. 1	Started business with cash	50,000
Dec. 3	Goods purchased for cash	30,000
Dec. 3	Furniture purchased for cash	5,000
Dec. 7	Sold goods for cash	10,000
Dec. 9	Sold goods to M. Rauf	8,000
Dec. 12	Goods purchased from Zulfiqar	5,000
Dec. 16	Goods sold to Ali and allowed him 10 % trade discount	6,000

1984		Rs.
Dec.22	Cash received from M. Rauf in full settlement of his account	7,600
Dec.25	Cash paid to Zulfiqar	1,900
	and he allowed discount	100
Dec.28	Cash paid for purchase of stationery	250
Dec.31	Paid office rent	800
Dec.31	Goods returned to Zulfiqar	500
Dec.31	Paid salaries to staff	900

4. **Journalise the following transactions.**

1994		
September	1.	Started business with Rs. 50,000, paid into Bank Rs. 20,000.
	2.	Bought furniture for Rs. 5,000 and machinery for Rs. 10,000.
	3.	Purchased goods for Rs. 14,000.
	6.	Sold goods for Rs. 8,000.
	8.	Purchased goods from Ishtiaq & Co. Rs. 11,000.
	10.	Paid telephone rent for the year by cheque Rs. 500.
	11.	Bought one typewriter for Rs. 2,100 from Universal Typewriter Co. on credit.
	15.	Sold goods to Khurram for Rs. 12,000.
	17.	Sold goods to Ajmal for Rs. 2,000 for cash.
	19.	Amount withdrawn from bank for personal use Rs. 1,500.
	20.	Withdrew from bank for business use Rs. 3,500.
	21.	Received cash from Khurram Rs. 11,900, discount allowed Rs. 100.
	22.	Paid into bank Rs. 5,800.
	25.	Goods worth Rs. 1,000 found defective were returned to Ishtaq & Co. and the balance of the amount due to them was settled by issuing a cheque in their favour.
	28.	Bought goods worth Rs. 2,100 from Aslam and supplied them to Akram at Rs. 3,000.
	30.	Akram returned goods worth Rs. 100, which in turn were sent to Aslam at Rs. 70.
	30.	Issued a cheque for Rs. 1,000 in favour of the landlord for rent for September.
	30.	Paid salaries to staff Rs. 1,500 and received from travelling salesman Rs. 2,000 for goods sold by him.
	30.	Paid travelling expenses Rs. 100.
	30.	Paid for: Charity Rs. 101
		Stationery Rs. 450
		Postage Rs. 249

NOTE:

When a cheque is issued for payment, there is decrease in the Bank Balance, so Bank account is credited.

CHAPTER - 5

LEDGER: THE MAIN BOOK OF ACCOUNTS

LEDGER: THE MAIN BOOK OF ACCOUNTS

Does the **journal replace the need for a Ledger?** No, the journal does not replace the ledger. The journal provides a complete listing of the daily transactions of a business. But it does not provide information about a specific account in one place. To know how much cash balance we have, for example, the accounting clerk would have to check all the journal entries in which cash is involved, and this is very labourious job; because, there are hundreds or even thousands of cash transaction are recorded on different pages of Journal. To avoid this difficulty, the debits and credits of journalised transactions are transferred to ledger accounts. Thus all the changes for a single account are located in one place-- in a ledger account. This makes it easy to determine the current balance of any account.

The book in which accounts are maintained, is called **Ledger**. Generally, one account is opened on each page of this book, but if transactions relating to a particular account are numerous, it may extend to more than one page. All transactions relating to that account are recorded therein chronologically. From journal each transaction is posted to at least two concerned accounts --- Debit side of one account and credit side of another account. Remember that, **if there are two accounts involved in a journal entry, it will be posted to two accounts in the ledger and if the journal entry consists of three accounts (compound entry) it will be posted to three different accounts in the ledger.**

This process of transferring information --- debits and credits --- from Journal to Ledger is known as **posting**. The goal of all transactions is ledger. **William Pickles** has rightly said that ledger is "**the destination of the entries made in the journal**". According to Arther Field house, ledger is the "**permanent store -- house of all the transactions**". But it must be remembered that transactions cannot be recorded directly in the ledger --- they must be routed through journal.

Transactions → Journal → Ledger.

So, the book in which all the transactions of a business concern are finally recorded in the concerned accounts in a summariesed and classified form, is called **Ledger**.

FEATURES :

The ledger has the following features :

1. It has two identical sides - left hand side (debit side) and right hand side (credit side).
2. Debit aspect of all the concerned transactions is recorded on Debit side, while credit aspect on credit side according to date.
3. The difference of the totals of the two sides represents balance. The excess of debit side over credit side indicates **debit balance**, while excess of credit side over debit side indicates **credit balance**. If the two sides are equal, there will be no balance.
4. Generally, balance is drawn at the year end and recorded on the lesser side to make the two sides equal. This balance is known as closing balance.
5. The closing balance of the current year will be the opening balance of the next year.

FORMS OF LEDGER ACCOUNTS :

There are two forms of ledger accounts;

1. Standard form.
2. Self- balancing form.

1. STANDARD FORM OF LEDGER ACCOUNT :

To understand clearly as to how to write the accounts in ledger, the standard form of an account is given below with two separate transactions;

Dr. **Salman Account in Ledger** Cr.

Date	References	J.R.	Amount Rs.	Date	References	J.R.	Amount Rs.
1990 Dec. 17	Cash A/c		600	1990 Dec. 11	Purchase A/c		1000

It appears that each account has got two similar sides -- the left hand side is called Debit (briefly Dr.) side and the right hand side is called Credit (briefly Cr.) side. Now a days these two words Dr. and Cr. are not used, because it is obvious that the left hand side is Debit side and right hand side is credit side.

Detailed discussions are being made below about the columns of an account :

1. DATE :

The date of the transaction is written in this column in two lines ___ in the first line the year and in the second line. first the name of month and thereafter the actual date.

2. REFERENCES:

In this column the name of the opposite account in the journal entry is written. For example, a journal entry contains two accounts, cash account is debited and sales is credited. While making the posting in the cash account, amount will be written on debit side of cash account in the amount column but in the reference column the opposite account (Sales account) will be written. In the same way while making the posting in the sales account, amount will be written on credit side of sales account in the amount column but in the reference the opposite account (Cash account) will be written.

3. JOURNAL REFERENCE (J. R.) :

The page number of the journal from where the transaction has been posted, is mentioned in this column. This will help in locating the entry in the Journal easily.

4. AMOUNT :

The amount of the transaction is recorded in this column.

NOTE : While making the posting in ledger accounts it should be borne in mind that the name of the same account will never appear in "Reference" column of that account. but the name of the apposite account should be stated.

POSTING PROCEDURE

1. Locate the ledger account for the first debit in the Journal entry.
2. Record the date in the Date column on the debit side of the account. The date is the date of transaction rather than the date of the posting.

3. Record the name of the opposite account (account credited in entry) in the reference column.
4. Record the page number of the Journal in the Journal Reference column from where the entry is being posted.
5. Record the amount of the debit in the "Amount column" on the debit side of the account.
6. Locate the ledger account for the first credit in the Journal entry and follow the same procedure.

BALANCING AN ACCOUNT

The difference between the two sides of an account is its balance. The balance is written on the lesser side to make the two sides equal. This process of equalising the two sides of an account is known as **Balancing**.

The rules for balancing an account are stated below:

1. Add up the amount columns of both the sides of an account and write the totals in a separate slip of paper.
2. Find out the difference of the two totals.
3. Write down the difference on the lesser side of the account.
4. Now total up both the sides and write the totals and draw double lines under them.
5. Again write the difference on the opposite side below the double lines.

If the Debit side of an account is heavier, its balance is known as **debit balance** and if credit side is heavier, its balance is known as **credit balance.** If the two sides of an account are equal , that account will show **zero balance.** The rules for determining the balance are as follows:

Total Debit	=	more than total credit	=	Debit balance
Total Credit	=	more than total Debit	=	Credit balance
Total Debit	=	Total credit	=	Nil balance

It may be noted that at the time of balancing an account debit balance is placed on the credit side and credit balance on the debit side. This balance is known as **closing balance** and when next year will start, it will be the opening balance. In other words, **what is closing balance in this year, is the opening balance of next year.**

NORMAL BALANCES

The normal balances of various accounts are illustrated below ;

Accounts of Assets normally have	=	Debit balance.
Accounts of Expenses normally have	=	Debit balance.
Accounts of Revenue normally have	=	Credit balance.
Accounts of Liabilities normally have	=	Credit balance.
Account of Owner (capital) normally has	=	Credit balance.

POSTING PROCEDURE ILLUSTRATED

Look at the posting of an entry from the Journal to the concerned accounts in ledger illustrated below ;

Page. 1

JOURNAL

Date	Details	L/F	Dr. Amount Rs.	Cr. Amount Rs.
1990				
Jan. 1	Cash Account .... Dr.	102	50,000	
	Capital Account	103		50,000
	(Owner invested cash).			

LEDGER

Cash Account 102

Dr. Date	References	J.R.	Amount Rs.	Date	References	J.R.	Cr. Amount Rs.
1990							
Jan. 1	Capital A/c	1	50,000				

Capital Account 103

Dr. Date	References	J.R.	Amount Rs.	Date	References	J.R.	Cr. Amount Rs.
				1990			
				Jan. 1	Cash A/c	1.	50,000

ILLUSTRATION NO. 1 SL.

Enter the following transactions in Journal and post them into the Ledger.

1990

Jan. 1. **Mr. Javed started business with cash Rs. 50,000.**

" " 2. **He purchased furniture for Rs. 10,000**

" " 3. **He purchased goods for Rs. 30,000**

" " 5. **He sold goods for cash Rs. 40,000**

" " 6. **He paid salaries Rs. 5,000.**

Solution:

JOURNAL

Date	Details	L/F.	Dr. Amount Rs.	Cr. Amount Rs.
1990				
Jan. 1	Cash Account .... Dr.	9	50,000	
	Capital Account	11		50,000
	(Owner invested cash)			
Jan. 2	Furniture Account .... Dr.	13	10,000	
	Cash Account	9		10,000
	(Purchased furniture for cash)			
Jan. 3	Purchase Account .... Dr.	15	30,000	
	Cash Account	9		30,000
	(Goods purchased for cash).			
Jan. 5	Cash Account .... Dr.	9	40,000	
	Sales Account	17		40,000
	(Sold goods for cash).			
Jan. 6	Salaries Account .... Dr.	19	5,000	
	Cash Account	9		5,000
	(Salaries paid).			

LEDGER

Cash Account (No. 9)

Debit Balance Rs. 45,000

Dr. Date	References	J.R.	Amount Rs.	Cr. Date	References	J.R.	Amount Rs.
1990				1990			
Jan. 1	Capital A/c	1	50,000	Jan. 2	Furniture A/c	1	10,000
Jan .5	Sales A/c	1	40,000	Jan. 3	Purchase A/c	1	30,000
				Jan. 6	Salaries A/c	1	5,000
					Balance c/d		*45,000*
			90,000				90,000

Capital Account (No. 11)

Credit balance Rs. 50,000

Dr. Date	References	J.R.	Amount Rs.	Cr. Date	References	J.R.	Amount Rs.
1990				1990			
Jan. 6	*Balance c/d*	*1*	*50,000*	Jan. 1	Cash A/c	1	50,000
			50,000				50,000

Dr. **Furniture Account (No. 13)** Cr.

Date	References	J.R.	Amount Rs.	Date	References	J.R.	Amount Rs.
1990				1990			
Jan. 2	Cash A/c	1	10,000	Jan. 6	*Balance c/d*		*10,000*
			10,000				10,000

Debit balance Rs. 10,000

Dr. **Purchases Account (No. 15)** Cr.

Date	References	J.R.	Amount Rs.	Date	References	J.R.	Amount Rs.
1990				1990			
Jan. 3	Cash A/c	1	30,000	Jan. 6	*Balance c/d*		*30,000*
			30,000				30,000

Debit balance Rs. 30,000

Dr. **Sales Account (No. 17)** Cr.

Date	References	J.R.	Amount Rs.	Date	References	J.R.	Amount Rs.
1990				1990			
Jan. 6	*Balance c/d*		*40,000*	Jan. 5	Cash A/c	1	40,000
			40,000				40,000

Credit balance Rs. 40,000

Dr. **Salaries Account (No. 19)** Cr.

Date	References	J.R.	Amount Rs.	Date	References	J.R.	Amount Rs.
1990				1990			
Jan. 6	Cash A/c	1	5,000	Jan. 6	*Balance c/d*		*5,000*
			5,000				5,000

Debit balance Rs. 5,000

(2) SELF - BALANCING FORM OF LEDGER ACCOUNT :

In practice the "Standard form" of the ledger account is not used. But it is usually used for examination purposes.

In practice. "Self-balancing form" of the ledger account is used. The advantage of this type of ledger account is that the balance of the account after each transaction is available at a glance from the last column. So, much time and labour is saved.

The specimen of self - balancing form of ledger account is given below:

Cash Account (No. 9)

Cash A/c in previous Illustration is prepared in this form.

Date	References	J.R.	Debit	Credit	Balance	
			Rs.	Rs.	Dr. Rs.	Cr. Rs.
1990						
Jan. 2	Capital A/c	1	50,000		50,000	
" 2	Furniture A/c	1		10,000	40,000	
" 3	Purchases A/c	1		30,000	10,000	
" 5	Sales A/c	1	40,000		50,000	
" 6	Salaries A/c	1		5,000	45,000	

ILLUSTRATION NO. 2 9L .

Enter the following transactions in Journal and post them into the Ledger -- (in self- balancing form).

1990

Jan. 1. Mr. Anwar started business with cash Rs. 40,000 and furniture Rs. 10,000.

" .2 Purchased goods on credit (on account) worth Rs. 15,000 from Ahsan.

" 3. Sold goods for cash Rs. 8,000.

" 4. Sold goods on credit to Shakeel for Rs. 5,000.

" 8. Cash received from Shakeel Rs. 4,900 in full settlement of his account.

Solution:

JOURNAL (Page No. 5) Dr. Cr.

Date	Details	L.F.	Amount Rs.	Amount Rs.
1990				
Jan. 1	Cash Account .... Dr.	5	40,000	
	Furniture Account.................................Dr.	7	10,000	
	Capital Account	9		50,000
	(Owner invested cash & Furniture)			
Jan. 2	Purchases Account .... Dr.	11	15,000	
	Ahsan account	13		15,000
	(Bought goods on credit)			
Jan. 3	Cash Account .... Dr.	5	8,000	
	Sales Account	15		8,000
	(Sold goods for cash).			

Jan. 4	Shakeel Account .... Dr.	17	5,000	
	Sales Account	15		5,000
	(Sold goods on credit)			
Jan. 8	Cash Account .... Dr.	5	4,900	
	Discount Account ....Dr.	19	100	
	Shakeel Account	17		5,000
	(Cash received and discount allowed).			

LEDGER

Cash Account (No. 5)

Debit Balance Rs. 52,900

Date	References	J.R.	Debit	Credit	Balance	
			Rs.	Rs.	Dr. Rs.	Cr. Rs.
1990						
Jan. 1	Capital A/c	5	40,000		40,000	
" 3	Sales A/c	5	8,000		48,000	
" 8	Shakeel A/c	5	4,900		52,900	

Furniture Account (No. 7)

Debit balance Rs. 10,000

Date	References	J.R.	Debit	Credit	Balance	
			Rs.	Rs.	Dr. Rs.	Cr. Rs.
1990						
Jan. 1	Capital A/c	5	10,000		10,000	

Capital Account (No. 9)

Credit balance Rs. 50,000

Date	References	J.R.	Debit	Credit	Balance	
			Rs.	Rs.	Dr. Rs.	Cr. Rs.
1990						
Jan. 1	Cash A/c	5		40,000		40,000
" "	Furniture A/c	5		10,000		50,000

Purchases Account (No. 11)

Date	References	J.R.	Debit	Credit	Balance	
			Rs.	Rs.	Dr. Rs.	Cr. Rs.
1990 Jan. 2	Ahsan A/c	5	15,000		15,000	

Debit balance Rs. 15,000

Ahsan Account (No. 13)

Date	References	J.R.	Debit	Credit	Balance	
			Rs.	Rs.	Dr. Rs.	Cr. Rs.
1990 Jan. 2	Purchases A/c	5		15,000		15,000

Credit balance Rs. 15,000

Sales Account (No. 15)

Date	References	J.R.	Debit	Credit	Balance	
			Rs.	Rs.	Dr. Rs.	Cr. Rs.
1990 Jan. 3	Cash A/c	5		8,000		8,000
" 4	Shakeel A/c	5		5,000		13,000

Credit balance Rs. 13,000

Shakeel Account (No. 17)

Date	References	J.R.	Debit	Credit	Balance	
			Rs.	Rs.	Dr. Rs.	Cr. Rs.
1990 Jan. 4	Sales A/c	5	5,000		5,000	
Jan . 8	Cash A/c	5		4,900		
" "	Discount A/c	5		100	Nil	

Nil Balance

Discount Account (No. 19)

Date	References	J.R.	Debit	Credit	Balance	
			Rs.	Rs.	Dr. Rs.	Cr. Rs.
1990 Jan. 8	Shakeel A/c	5	100		100	

Debit balance Rs. 100

TRIAL BALANCE

The fundamental principle of Double entry system is that **at any stage , the total of Debits must be equal to the total of credits.** If entries are recorded and posted correctly, the ledger will reflect equal debits and credits, and the **total credit balances will then be equal to the total debit balances.**

Every business concern prepares Final Accounts at the end of the year to ascertain the result of the activities of the whole year. To ensure correct result, the concern must be free from doubt that the books of accounts have been correctly recorded throughout the year. Trial Balance is prepared to test the arithmetical accuracy of the books of accounts. As we know that under double entry system for each and every transaction one account is debited and another account is credited with an equal amount. If all the transactions are correctly recorded strictly according to this rule, the total amount of Debit side of all the ledger accounts must be equal to that of Credit side of all the ledger accounts. This verification is done through **Trial Balance.**

If the trial balance agrees, we may reasonably assume that the books are correct. On the other hand, if it does not agree, it indicates that the books are not correct - there are mistakes somewhere. The mistakes are to be detected and corrected -- otherwise, correct result cannot be ascertained. There are, however, a few types of errors which the trial balance cannot detect. In other words, the trial balance will agree in spite of the existence of those errors.

The trial balance is not an absolute or solid proof of the accuracy of books of accounts. Thus, if trial balance agrees, there may be errors or may not be errors. But if it does not agree, certainly there are errors.

The trial balance serves two main purposes.

1. To check the equality of debits and credits -- an arithmetical or mathematical test of accuracy.
2. To provide information for use in preparing Final Accounts.

Thus in the light of above discussion a Trial Balance may be defined as ``**an informal accounting schedule or statement that lists the ledger account balances at a point in time and compares the total of debit balances with the total of credit balances.**

METHODS OF PREPARING TRIAL BALANCE:

There are three methods for the preparation of Trial Balance;

1. Total or Gross Trial Balance.
2. Balance or Net Trial Balance.
3. Total - Cum - Balance Trial Balance.

The methods No. 1 and 2 are discussed below in details :

1. TOTAL OR GROSS TRIAL BALANCE :

Under this method the two sides of all the ledger accounts are totaled up. Thereafter, a list of all the accounts is prepared in a separate sheet of paper with two ``Amount" columns on the right-hand side. The first one for debit amounts and the second one for credit amounts. The total of debit side and credit side of each account is then placed on ``Debit Amount" column and ``Credit Amount" column respectively of the list. Finally, the two columns are added separately to see whether they agree or not. This method is generally not followed in practice.

2. BALANCE OR NET TRIAL BALANCE :

Under this method first of all the balances of all ledger accounts are drawn. Thereafter, the debit balances and credit balances are recorded in "Debit Amount" column and "Credit Amount" column respectively and the two columns are added separately to see whether they agree or not. **This is the most popular method and generally followed.**

The various steps involved in the preparation of "Balance Trial Balance" are given below;

1. Find out the balance of each account in ledger.
2. Write up the name of account in the first column.
3. Record the account number in second column.
4. Record the debit balance of each account in Debit column and credit balance in credit column.
5. Add up the debit and credit columns and record the totals.

ILLUSTRATION NO. 3 SL

Prepare the Balance or Net Trial Balance from the balances extracted in illustration No. 2.

TRIAL BALANCE

as at 8.1.1990

S. No	Account Names	A/c No.	Debit	Credit
1.	Cash Account	5	52,900	
2.	Furniture Account	7	10,000	
3.	Capital Account	9	--	50,000
4.	Purchases Account	11	15,000	
5.	Ahsan Account	13	--	15,000
6.	Sales Account	15	--	13,000
7.	Shakeel Account	17	--	--
8.	Discount Account	19	100	--
			78,000	78,000

NOTE:

If an account shows zero balance, it is not necessary to record it in Trial Balance.

ILLUSTRATION NO. 4 SL.

Journalise the following transactions, post them in ledger and prepare a Trial Balance :-

1990

Jan. 1. Started business with cash Rs. 1,00,000.
" 2. Opened Bank Account with Rs. 50,000.
" 3. Purchased furniture for cash Rs. 5,000.
" 4. Purchased goods for cash Rs. 15,000.
" 5. Purchased goods from Karachi Stores worth Rs. 20,000 on credit basis.
" 7. Sold goods for cash Rs. 13,000.
" 8. Sold goods to Rafiq & Sons for Rs. 11,000.
" 9. Payment made to Karachi Store Rs. 15,000 by cheque.
" 11. Cheque received from Rafiq & Sons for Rs. 8,000 and paid into the bank.
" 14. Goods returned to Karachi Store worth Rs. 1,500.
" 16. Goods returned by Rafiq & Sons for Rs. 1,000.
" 17. Cash paid to Karachi Store Rs. 3,400 in full settlement of their account.
" 20. Cash received from Rafiq & Sons Rs. 1,950 in full settlement of their account.
" 22. Goods lost by fire Rs. 2,000.
" 24. Goods taken away by the proprietor for his personal use Rs. 1,500.
" 26. Purchased a typewriter for Rs. 5,000 and paid by cheque.
" 28. Goods distributed as free samples worth Rs. 2,000.
" 31. Paid salaries Rs. 3,000 and rent Rs. 2,000 by cheques.

Solution :

JOURNAL (Page No. 6)

Date	Details	L.F.	Dr. Amount Rs.	Cr. Amount Rs.
1990				
Jan. 1	Cash Account .... Dr.	5	1,00,000	
	Capital Account	7		1,00,000
	(Owner invested cash)			
Jan. 2	Bank account .... Dr.	9	50,000	
	Cash account	5		50,000
	(Cash deposited into bank)			
Jan. 3	Furniture A/c .... Dr.	11	5,000	
	Cash A/c	5		5,000
	(Bought furniture for cash)			

Jan. 4	Purchases A/c .... Dr.	13	15,000	
	Cash A/c	5		15,000
	(Bought goods for cash)			
Jan. 5	Purchases A/c .... Dr.	13	20,000	
	Karachi Store A/c	15		20,000
	(Bought goods on credit)			
Jan. 7	Cash A/c .... Dr.	5	13,000	
	Sales A/c	17		13,000
	(Goods sold for cash)			
Jan. 8	Rafiq & Sons A/c .... Dr.	19	11,000	
	Sales A/c	17		11,000
	(Goods sold on credit)			
Jan. 9	Karachi Store A/c .... Dr.	15	15,000	
	Bank A/c	9		15,000
	(Payment made by cheque)			
Jan. 11	Bank A/c .... Dr.	9	8,000	
	Rafiq & Sons A/c	19		8,000
	(Cheque received and paid into the bank)			
Jan. 14	Karachi Store A/c .... Dr.	15	1,500	
	Purchases Returns A/c	21		1,500
	(Goods returned)			
Jan. 16	Sales Returns Account .... Dr.	23	1,000	
	Rafiq & Sons Account	19		1,000
	(Goods returned by customer)			
Jan. 17	Karachi Store account .... Dr.	15	3,500	
	Cash account	5		3400
	Discount A/c	25		100
	(Cash paid & discount received)			
Jan. 20	Cash A/c .... Dr.	5	1,950	
	Discount A/c ....Dr.	25	50	
	Rafiq & Sons A/c	19		2,000
	(Cash received & Discount allowed)			
Jan. 22	Loss by fire A/c .... Dr.	27	2,000	
	Purchases A/c	13		2,000
	(Goods lost by fire)			

Jan. 24	Drawings A/c .... Dr.	29	1,500	
	Purchases A/c	13		1,500
	(Goods taken away by proprietor)			
Jan. 26	Typewriter A/c .... Dr.	31	5,000	
	Bank A/c	9		5,000
	(Bought typewriter and paid by cheque)			
Jan. 28	Advertisement A/c .... Dr.	33	2,000	
	Purchases A/c	13		2,000
	(Goods distributed as free samples)			
Jan. 31	Salaries A/c .... Dr.	35	3,000	
	Rent A/c .... Dr.	37	2,000	
	Bank A/c	9		5,000
	(Expenses paid by cheques)			
	Total C/f		2,60,500	2,60,500

LEDGER

Cash Account (No. 5)

Dr. Cr.

Date	References	J.R.	Amount Rs.	Date	References	J.R.	Amount Rs.
1990				1990			
Jan. 1	Capital A/c	6	1,00,000	Jan. 2	Bank A/c	6	50,000
7	Sales A/c	6	13,000	3	Furniture A/c	6	5,000
20	Rafiq & Sons A/c	7	1,950	4	Purchases A/c	6	15,000
				17	Karachi Store A/c	7	3,400
				31	*Balance c/d*		*41,550*
			1,14,950				1,14,950

Debit Balance Rs. 41,550

Capital Account (No. 7)

Dr. Cr.

Date	References	J.R.	Amount Rs.	Date	References	J.R.	Amount Rs.
1990				1990			
Jan.31	*Balance c/d*		*1,00,000*	Jan. 1	Cash A/c	6	1,00,000
			1,00,000				1,00,000

Credit balance Rs. 1,00,000

Debit balance Rs. 33,000

Dr. **Bank Account (No. 9)** Cr.

Date	References	J.R.	Amount Rs.	Date	References	J.R.	Amount Rs.
1990				1990			
Jan. 2	Cash A/c	6	50,000	Jan. 9	Karachi Store A/c	6	15,000
" "	Rafiq & Sons A/c	6	8,000	" 26	Typewriter A/c	7	5,000
				" 31	Salaries A/c	7	3,000
				" 31	Rent A/c	7	2,000
				" 31	*Balance c/d*		*33,000*
			58,000				58,000

Debit balance Rs. 5,000

Dr. **Furniture Account (No. 11)** Cr.

Date	References	J.R.	Amount Rs.	Date	References	J.R	Amount Rs.
1990				1990			
Jan. 3	Cash A/c	6	5,000	Jan.31	*Balance c/d*		*5,000*
			5,000				5,000

Debit Balance Rs. 29,500

Dr. **Purchases Account (No. 13)** Cr.

Date	References	J.R.	Amount Rs.	Date	References	J.R.	Amount Rs.
1990				1990			
Jan. 4	Cash A/c	6	15,000	Jan. 22	Loss by fire A/c	7	2,000
5	Karachi Store A/c	6	20,000	" 24	Drawing A/c	7	1,500
				" 28	Advertisement A/c		2,000
				" 31	*Balance c/d*		*29,500*
			35,000				35,000

No. Balance

Dr. **Karachi Store Account (No. 15)** Cr.

Date	References	J.R.	Amount Rs.	Date	References	J.R.	Amount Rs.
1990				1990			
Jan. 9	Bank A/c	6	15,000	Jan. 5	Purchases A/c	6	20,000
" 14	Purchases Returns A/c	6	1,500				
" 17	Cash A/c	7	3,400				
" 17	Discount A/c	7	100				
			20,000				20,000

Sales Account (No. 17)

Dr. Cr.

	Date	References	J.R.	Amount Rs.	Date	References	J.R.	Amount Rs.
	1990				1990			
Debit balance Rs. 24,000	Jan.31	*Balance c/d*		*24,000*	Jan. 7	Cash A/c	6	13,000
					" 8	Rafiq & Sons A/c	6	11,000
				24,000				24,000

Rafiq & Sons Account (No. 19)

Dr. Cr.

	Date	References	J.R.	Amount Rs.	Date	References	J.R.	Amount Rs.
	1990				1990			
No Balance	Jan. 8	Sales A/c	6	11,000	Jan. 11	Bank A/c	6	8,000
					" 16	Sales Returns A/c	7	1,000
					" 20	Cash A/c	7	1,950
					" 20	Discount A/c	7	50
				11,000				11,000

Purchases Returns Account (No. 21)

Dr. Cr.

	Date	References	J.R.	Amount Rs.	Date	References	J.R.	Amount Rs.
	1990				1990			
Credit balance Rs. 1500	Jan.31	*Balance c/d*		*1500*	Jan. 14	Karachi Store A/c	6	1500
				1500				1500

Sales Returns Account (No. 23)

Dr. Cr.

	Date	References	J.R.	Amount Rs.	Date	References	J.R.	Amount Rs.
	1990				1990			
Debit balance Rs. 1,000	Jan.16	Rafiq & Sons A/c	7	1,000	Jan. 31	*Balance c/d*		*1,000*
				1,000				1,000

Discount Account (No. 25)

Dr. Cr.

	Date	References	J.R.	Amount Rs.	Date	References	J.R.	Amount Rs.
	1990				1990			
Credit Balance Rs. 50	Jan.20	Rafiq & Sons A/c	7	50	Jan.17	Karachi Store A/c	7	100
	Jan.31	*Balance c/d*		*50*				
				100				100

Dr. **Loss by Fire Account (No. 27)** Cr.

Date	References	J.R.	Amount Rs.	Date	References	J.R.	Amount Rs.
1990				1990			
Jan.22	Purchase A/c	7	2,000	Jan.31	*Balance c/d*		*2,000*
			2,000				2,000

Debit Balance Rs. 2,000

Dr. **Drawings Account (No. 29)** Cr.

Date	References	J.R.	Amount Rs.	Date	References	J.R.	Amount Rs.
1990				1990			
Jan.24	Purchases A/c	7	1,500	Jan.31	*Balance c/d*		*1,500*
			1,500				1,500

Debit balance Rs. 1,500

Dr. **Typewriter Account (No. 31)** Cr.

Date	References	J.R.	Amount Rs.	Date	References	J.R.	Amount Rs.
1990				1990			
Jan.26	Bank A/c	7	5,000	Jan.31	*Balance c/d*		*5,000*
			5,000				5,000

Debit balance Rs. 5,000

Dr. **Advertisement Account (No. 33)** Cr.

Date	References	J.R.	Amount Rs.	Date	References	J.R.	Amount Rs.
1990				1990			
Jan.28	Purchases A/c	7	2,000	Jan.31	*Balance c/d*		*2,000*
			2,000				2,000

Debit Balance Rs. 2,000

Dr. **Salaries Account (No. 35)** Cr.

Date	References	J.R.	Amount Rs.	Date	References	J.R.	Amount Rs.
1990				1990			
Jan.31	Bank A/c	7	3,000	Jan.31	*Balance c/d*		*3,000*
			3,000				3,000

Debit balance Rs. 3,000

Dr. **Rent Account (No. 37)** Cr.

Date	References	J.R.	Amount Rs.	Date	References	J.R.	Amount Rs.
1990 Jan.31	Bank A/c	7	2,000	1990 Jan.31	*Balance c/d*		*2,000*
			2,000				2,000

Debit balance Rs. 2,000

TRIAL BALANCE

as at 31.1.1990

S. No	Account Names	A/c No.	Debit Rs.	Credit Rs.
1.	Cash Account	5	41,550	
2.	Capital Account	7	--	1,00,000
3.	Bank Account	9	33,000	--
4.	Furniture Account	11	5,000	---
5.	Purchases Account	13	29,500	
6.	Sales Account	17	--	24,000
7.	Purchases Returns Account	21	--	1,500
8.	Sales Returns Account	23	1,000	--
9.	Discount Account	25	--	50
10.	Loss by fire Account-	27	2,000	--
11.	Drawings Account	29	1,500	--
12.	Typewriter Account	31	5,000	--
13.	Advertisement Account	33	2,000	--
14.	Salaries Account	35	3,000	--
15.	Rent Account	37	2,000	--
			1,25,550	1,25,550

NOTE:

Accounts No. 15 and 17 have shown zero balance, so there is no need to consider these two accounts while preparing Trial balance.

ACCOUNTING CYCLE TO THE TRIAL BALANCE:

The different stages of accounting cycle are given below:

1. DOCUMENTING:

All transactions which have taken place in a business concern and have no written evidences (vouchers) are noted on **business printed forms called source documents.**

2. RECORDING:

In this stage all business transactions with their source documents are recorded chronologically in Journal.

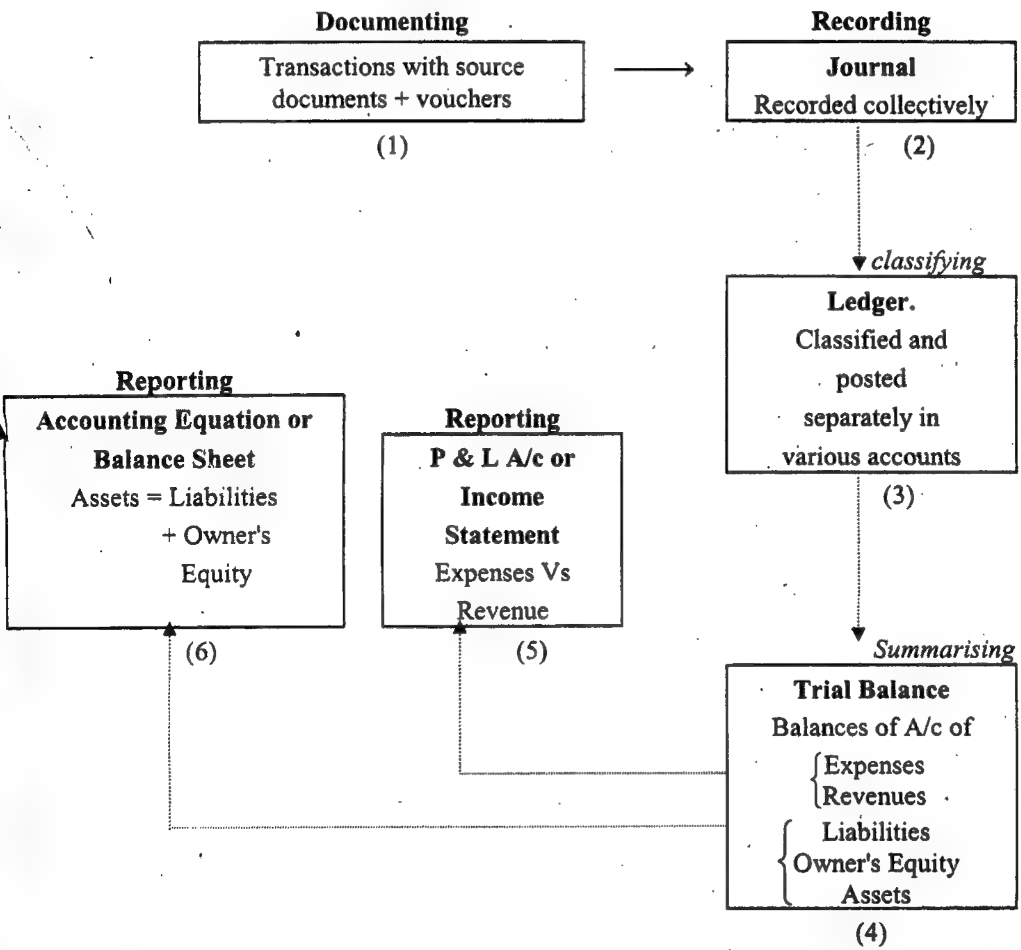
3. SUMMARISING:

The debit and credit aspects of transactions are transferred from journal to the concerned accounts in ledger. A trial balance is prepared which is a summary of the transactions which have taken place during an accounting period.

REPORTING:

The Trial Balance provides information to prepare financial statements or Final Accounts for the people who need them.

The accounting cycle is illustrated below;



TEST YOUR KNOWLEDGE

1. **Fill up the gaps with one of the given words :**
   (a) Excess of debit over credit is called .... balance. (Debit / Credit)
   (b) The process of recording a transaction in Ledger is called .... (Journalising/ Posting)
   (c) While balancing an account the difference of the two sides is recorded on .... side. (Larger / Smaller)
   (d) Expenses normally show .... balance. (Debit / Credit)
   (e) Liabilities normally show .... balance. (Debit / Credit)

2. **While preparing the Ledger account of a debtor on which side of the account you will show**
   (a) Opening debit balance.
   (b) Closing debit balance.
   (c) Opening credit balance.
   (d) Closing credit balance.

Ans: *[(a) (Debit), (b) (Credit), (c) (Credit) (d) (Debit)]*

QUESTIONS

1. What is Ledger? Why it is called "King of all Books"? What are its advantages?
2. How is an account balanced? What do you understand by the ``debit balance" and "credit balance"?
3. Explain the term ``Balancing of Account".
4. Distinguish between Journal and Ledger.

PROBLEMS

1.SL. **Mr. Saeed started his business with cash Rs. 65,000, Furniture Rs. 20,000 and Building Rs. 1,00,000 on Ist January, 1990.**

His transaction during the month were as follows :

1990

Jan. 1 Purchased goods on account from Asif worth Rs. 15,000.
" 2 Purchased goods for cash Rs. 30,000.
" 3 Sold goods for cash Rs. 22,000.
" 5 Sold goods to Shahid & Sons for Rs. 14,000.
" 8 Purchased a typewriter for Rs. 8,000.
" 10 Bought an iron safe for Rs. 4,000.
" 12 Made purchases from Salman Rs. 18,000.
" 14 Opened Bank Account with Rs. 20,000.

" 16	Received a cheque from Shahid & Sons for Rs. 9,000.
" 18	Issued a cheque in favour of Asif for Rs. 8,000.
" 20	Cheque received from Shahid & Sons paid into the bank.
" 22	Goods sold for cash Rs. 19,000 and paid into the bank.
" 24	Paid a cheque to Salman for Rs. 17,800 in full settlement of his account.
" 26	Received cash from Shahid & Sons Rs. 4,900 in full settlement of their account.
" 28	Withdrew cash for personal use Rs. 3,000.
" 30	Paid electricity bill Rs. 1,000.
" 31	Paid the following expenses by cheques: Salaries Rs. 2,000, insurance Rs. 1,000.

Req: Journalise the above transactions and post them into the ledger.

2. SL Journalise the following transactions, post in the ledger and prepare a trial balance:

1989

Jan. 1	Mr. Nadeem commenced business with Rs. 40,000 cash, furniture worth Rs. 5.000, motor-car valued at Rs. 12,000 and stock worth Rs. 20,000.
" 3	Deposited into Bank Rs. 38,000.
" 5	Purchased goods on account from Imran worth Rs. 9,000.
" 6	Sold goods to Babar on credit for Rs. 6,000.
" 8	Bought office supplies from Rafiq & Co. for cash Rs. 200.
" 10	Goods sold for cash Rs. 2,000.
" 11	Paid Rs. 600 as travelling expenses to salesman.
" 12	Withdrew from the bank for personal use Rs. 1,000.
" 16	Withdrew from bank for office use Rs. 3,000.
" 19	Issued a cheque to Imran of Rs. 8,800 in full settlement of his account.
" 22	Paid carriage in cash Rs. 400.
" 25	Received a cheque from Babar for Rs. 6,000.
" 31	Paid rent of the building by cheque Rs. 300.
" 31	Commission received Rs. 200.
" 31	Bank charges made by bank Rs. 25.

Ans: *[Trial Balance total : Rs, 85,400]*

3. SL **Enter the following transactions in the Journal of a trader. Post in the Ledger and prepare a trial Balance :**

1992

Feb. 1	Started business with cash Rs. 100,000.
" 2	Bought goods from Mahmood & Co. worth Rs. 50,000.
" 2	Bought furniture for cash Rs. 8,000.
" 2	Sold goods to Qasim Bros. for Rs. 16,000.
" 3	Purchased stationery for cash Rs. 4,000.

" 4 Paid Mahmood & Co. Rs. 30,000 in cash.
" 5 Sold goods to Waheed & Sons Rs. 20,000.
" 5 Received cash from Qasim Bros. Rs. 15,400 and discount allowed Rs. 600.
" 6 Paid carriage Rs. 800
" 8 Bought goods for cash Rs. 6,000.
" 9 Sold goods to Rashid Rs. 34,000.
" 10 Bought goods from Faisal & Co. Rs. 26,000.
" 11 Paid Mahmood & Co. Rs. 19,000 in full settlement of their account.
" 12 Paid wages Rs. 400.
" 13 Paid carriage Rs. 800
" 14 Purchased goods from Mahmood & Co. Rs. 30,000.
" 15 Purchased goods for cash Rs. 8,000.
" 17 Goods sold to Waheed & Sons for Rs. 36,000.
" 18 Cash received from Waheed & Sons Rs. 40,000.
" 19 Bought goods from Ahsan Rs. 15,000.
" 19 Sold goods for cash Rs. 16,000.
" 20 Paid wages in cash Rs. 800.
" 21 Paid to Ahsan Rs. 14,400 in full settlement of his account.
" 22 Sold goods to Qasim Bros. Rs. 26,000.
" 23 Bought goods from Mahmood & Co. for Rs. 48,000.
" 24 Cash purchases Rs. 14,600.
" 25 Cash paid to Mahmood & Co. Rs. 40,000.
" 26 Cash received from Qasim Bros. Rs. 20,000.
" 27 Paid carriage Rs. 800.
" 28 Paid electricity bill Rs. 1,000.
" 28 Paid rent Rs. 1600.
" 29 Owner withdrew cash for personal use Rs. 3,000.
" 29 Paid salaries Rs. 2,800.

Ans: *[Trial Balance Total Rs. 3,13,000]*

CHAPTER - 6

ACCOUNTING FOR BILLS OF EXCHANGE

ACCOUNTING FOR BILLS OF EXCHANGE

No businessman wants to sell goods on credit to his customers who may prove unable or unwilling to pay their debts. Today, however, in every field of retail trade it appears that sales and profits can be increased by selling goods on credit basis. The manufacturers and the wholesalers sell goods mostly on credit. Credit is a very powerful instrument to promote sales, so most of the business transactions, in most business concerns, are carried out on credit basis.

A bill of exchange is a method of payment used between businessmen which has certain advantages over other methods of payment. It has a very precise definition which is given below, from the Bills of Exchange Act 1882. An illustration is given in Figure 1 and is explained in the notes below it. It is better to read the definition first and then see (look at) figure 1 and notes how they fit the definition. A Bill of Exchange is defined as:

"An unconditional order in writing, addressed by one person to another, signed by the person giving it, requiring the person to whom it is addressed to pay on demand or at a fixed or determinable future time a sum certain in money to or to the order of a specified person, or to the bearer".

The students should keep in mind the following points to understand the definition.

(a). The person who writes out the order to pay is called the **drawer**.

(b) The person upon whom the bill of exchange is drawn (who is ordered to pay) is called the **drawee.**

(c) The drawee may 'accept' the bill. This is a special use of the word 'accept' because it means that he accepts to pay the amount payable expressed in the bill, i.e. if he accepts the obligation to pay he writes 'accepted' across the face of the bill and signs it. From that time on he is known as the 'acceptor' of the bill and has absolute liability to honour the bill on the due date.

(d) The amount of money must be mentioned clearly. For example, I cannot make out a bill requiring someone to pay the value of my car or house. That is an uncertain sum. It must say 'Five thousand rupees or ten thousand rupees'.

(e) The time must be fixed or at least be determinable. For example, '60 days after date' is quite easily determinable. If the bill is made out on 1st July, it will be 29th August.

(f) The person who is entitled to receive the money from the acceptor is called the 'payee'. It is usually the drawer who is supplying goods to the value of the bill, and wants to be paid for them. If the drawer decides, the bill can be made payable to someone else by endorsing it. That is why the definition says, to pay....... to, or to the order of, a specified person.

(g) A bill can be made payable to a bearer, but it is risky, since any finder of the bill or any thief, can claim the money from the acceptor.

Now read the definition again and see the Figure 1 given below.

Exchange For Rs. 10,000 1st July, 1991

Stamp

90 days after date pay to Waseem & Co. or the order of Waseem & Co. a sum of rupees ten thousand only for value received ....

To

M. Saleem & Co.,	**Waseem & Co.,**
2172, Ferozpur Road,	42, The Mall,
Lahore.	Lahore.

Figure 1.

NOTES:

(a) This bill is drawn by Waseem & Co., so the drawer of the bill is Waseem & Co.

(b) The bill is drawn upon M. Saleem & Co., so they are drawee of the bill. They have not yet accepted the bill, and so are not liable to pay it at maturity.

(c) The bill is an unconditional order in writing. It says 'pay ten thousand rupees to Waseem & Co.' It does not say 'provided you are in funds. It just says 'pay!'.

(d) It is addressed by one person (Waseem & Co.) to another (M. Saleem & Co.) and is signed by the person giving it (Waseem & Co.).

(e) The date is easily determinable, it is 90 days after 1st July, which is 29 September, 19....

(f) The sum of money is very certain, ten thousand rupees.

(g) The bill is payable to, or to the order of, Waseem & Co.

How A Bill of Exchange Works?

How a bill of exchange operates, is illustrated in Figure 2 and Figure 3, but first we should read the following points.

(1) A person who wants to purchase goods but has no money, may agree to accept a bill of exchange drawn upon him at some future date for the value of the goods he wants to purchase. For example, Mr. B (a retail trader) wishes to purchase furniture from a furniture manufacturer (Mr. A) but has no money. Mr. A is agreed to sell furniture for a 90 days credit worth Rs. 10,000.

(2) The drawer (Mr. A) draws a bill for Rs. 10,000 on the customer (Mr. B), the drawee, who accepts it (thus becoming the acceptor of the bill) and returns it to the drawer. The drawer delivers the furniture and has a 90 days bill for Rs. 10,000.

(3) He can keep the bill till due date and present it on the due date before the acceptor.

The use of Bills of Exchange.

(4) When a drawee (the acceptor) acknowledges the obligation in the bill he is bound by law to honour the bill on the due date. If he is a reputable person the bill is as good as money, and any bank will discount it. There are special kinds of banks which do this job and they are called **discount houses**. What do the discount houses do? They cash the bill by giving the drawer the present value of the bill.

Present value = Face value of the bill – interest at an agreed rate for the number of days the bank has to wait.

So the drawer who discounts the bill with the bank gets less than the face value.

(5) On the due date the bank will present the bill to the acceptor, who honours it by paying the full value. The bank has earned the amount of interest it deducted when it discounted the bill.

Where does the acceptor get the money to honour the bill? The answer is that he was given 90 days to sell the goods at profit, and therefore, he is liable to honour the bill.

Now it is hoped that the students will be able to follow what is happening in diagrams No. 2 and No. 3.

Before the use of a Bill of Exchange:

Trading activity before the use of a Bill of Exchange.

(1) The general public (customers)

They want to buy goods but the shop has nothing to sell.

→

(2) Retail Trader

Mr. B. He wishes to buy goods and stocks up the shop but has no money to pay.

(4) Mercantile Banker

Discount House:

Has money to lend but no borrowers.

(3) Manufacturer

Mr. A Having plenty of goods in factory but no orders.

Figure 2

You can understand the Figure 2 given above with the help of the following notes:

(a) Business activities cannot proceed because the retail trader (Mr. B) has nothing to sell and has no money to buy goods.

(b) We need a system by which the retailer can purchase goods without paying for them at the moment and which enables the manufacturer (Mr. A) to be paid immediately.

(c) Since a Bill of Exchange from a reputable trader is almost as good as money, it will be acceptable to banks. They have plenty of money to lend out to reliable customers so, they will advance money to the holder of Bills of Exchange.

Now, look at Figure 3.

Business activity under the influence of a Bill of Exchange

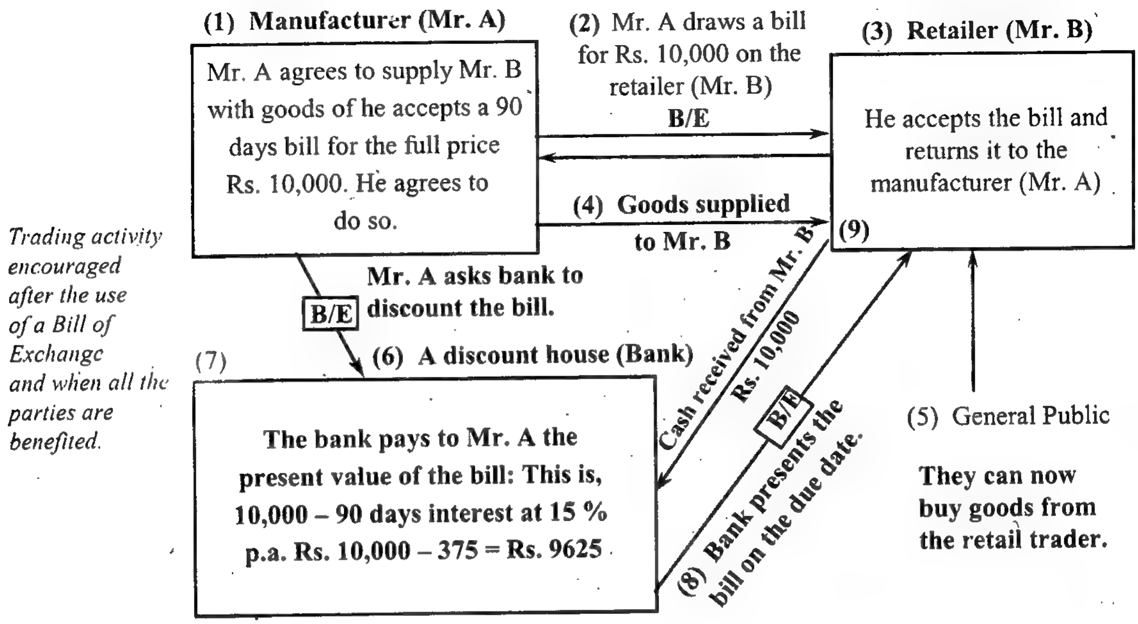


Figure 3

The result is that a Bill of Exchange is a useful instrument to increase business activities, and is beneficial to all the parties involved.

TYPES OF BILL OF EXCHANGE:

The bills of exchange are classified on two different basis: (1) On the basis of period. (2) On the basis of object.

(1) Period:

On the basis of period bills are of two types:

(a) Demand bills of exchange:

There is no fixed date for the payment of such bill. They become payable at any time, when they are presented by the holder.

(b) Term bills of exchange:

These bills are payable after specified period of time. The period after which these bills become due for payment is called **tenor**.

(2) Object:

On the basis of purpose of writing the bills, the bills can be classified as:

(a) Trade Bills:

These bills are drawn and accepted against the sale and purchase of goods on credit. These are drawn by the seller (creditor) and accepted by the buyer (debtor).

(b) **Accommodation Bills:**

Such bills do not involve any sale and purchase of goods, rather they are drawn without any consideration. The purpose is to help one party or both the parties financially.

CLASSIFICATION OF BILLS OF EXCHANGE:

The bills can be divided into two classes given as under:

(a) **Inland Bills:**

These bills are drawn in a country upon persons living in the same country or made payable in the same country. Both drawer and acceptor reside in the same country.

(b) **Foreign Bills:**

These bills are drawn in one country and accepted and payable in another country, e.g. a bill drawn in Pakistan and accepted and payable in London.

ACCEPTANCE OF A BILL OF EXCHANGE:

Every bill has to be accepted by the drawee. After the drawer has prepared the draft, it is sent to the drawee for acceptance. Acceptance is an indication on part of the drawee that he is willing to accept the liability under the bill. Acceptance is given by putting his signature across the face of the bill together with the place and date. After acceptance, a bill of exchange is also called acceptance.

HOW TRANSACTIONS RELATING TO BILLS OF EXCHANGE ARE RECORDED?

In a business concern, numerous bills of exchange are drawn and accepted. Generally under such conditions special journals are used to record bills of exchange, called Bill Receivable Journal and Bill Payable Journal. From these two journals the totals are posted to Bills Receivable account and Bills Payable account respectively.

EVERY BILL HAS TWO DIFFERENT ASPECTS:

(a) To the drawer who has sold goods and wants to be paid for them, it is a bill receivable, he hopes to receive money on the due date. It is a sort of asset for the drawer and as good as money.

(b) To the acceptor of the bill, who has bought goods on credit and has agreed to honour the bill on the due date, it is a bill payable. The acceptor must arrange in due course the funds available to honour the bill when it falls due.

ACCOUNTING TREATMENT FOR BILLS RECEIVABLE AND BILLS PAYABLE

We can understand the accounting of bills of exchange with the help of an illustration. Let us suppose, Mr. Salman is a manufacturer of shoes and Mr. Imran is a retail trader of shoes. Mr. Imran (the buyer) wishes to buy shoes (goods) from the manufacturer (seller) but has no money. He is agreed to accept a bill of exchange for 90 days, if goods are sold to him on credit basis. So both the parties agreed. Mr. Salman supplies goods to Mr. Imran worth Rs. 10,000 for a 90 days credit and draws upon him a bill for the full value of goods for 90 days on 1st Jan., 1991. The illustration given above can be summarized in the Figure 4 given below:

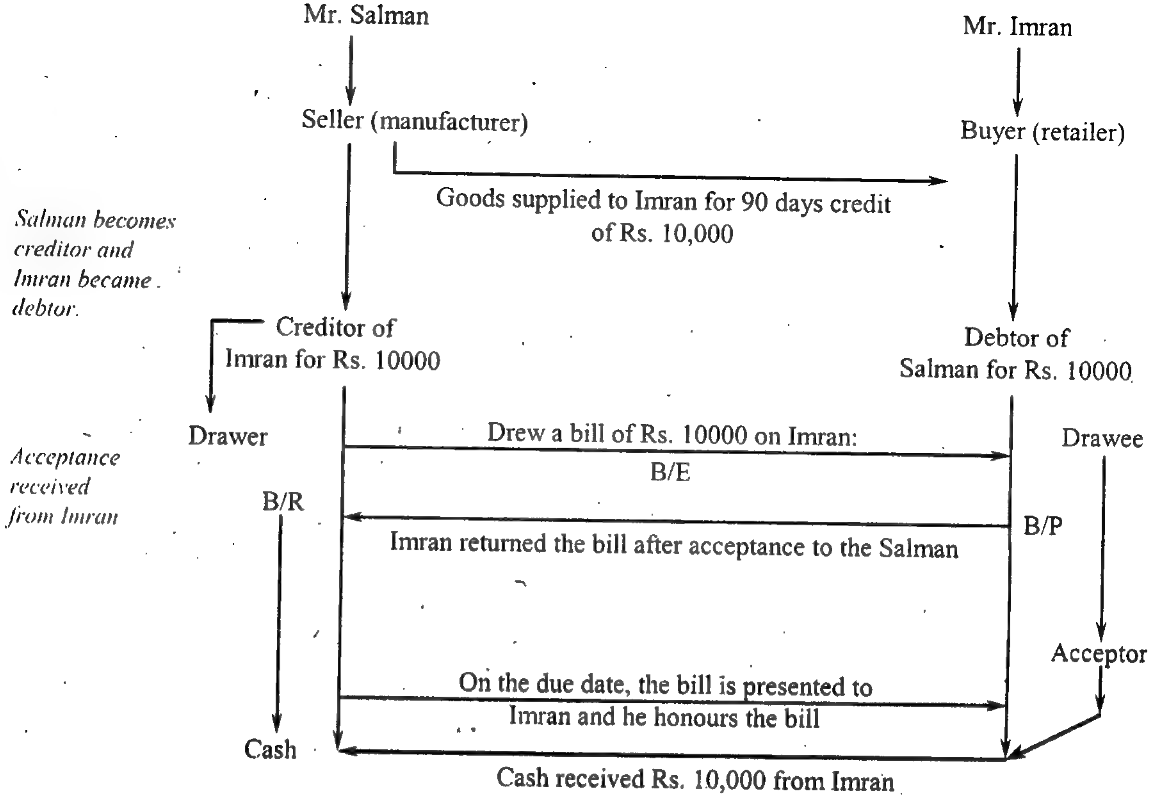


Figure 4

We have seen that there are three transactions which have taken place:

(1) Mr. Salman sold goods to Mr. Imran worth Rs. 10,000 on credit basis.

(2) Mr. Salman drew a bill of exchange on Mr. Imran for 90 days for Rs. 10,000.

(3) On the due date the bill was presented to Mr. Imran and he honoured the bill (met his obligation on the due date).

Now we shall see, how these transactions are recorded in journal of Mr. Salman and Mr. Imran.

Mr. Salman's Journal

Transaction No. 1

Mr. Salman sold goods to Mr. Imran for Rs. 10,000 on credit basis. The journal entry is:

Imran became debtor.(Asset)	1st Jan. 1991		Rs.	Rs.
		Imran A/C	Dr. 10,000	
		Sales A/C		10,000
		(Goods sold for credit)		

Transaction No. 2

Salman drew a bill on Imran for 90 days. The journal entry is:

Increase in one asset and decrease in other asset	1st Jan. 1991		Rs.	Rs.
		Bill receivable A/C	Dr. 10,000	
		Imran A/C		10,000
		(Acceptance received from Imran instead of cash.)		

Transaction No. 3

On the due date, acceptor honoured the bill. The entry is:

			Rs.	Rs.
Bill converted into cash. (Three days as grace period)	4 April 1991	Cash/Bank A/C	Dr. 10,000	
		Bill Receivable A/C		10,000
		(Received cash on presentation of acceptance.)		

Mr. Imran's Journal

Transaction No. 1

Bought goods from Mr. Salman for Rs. 10,000 on credit basis. The journal entry is:

			Rs.	Rs.
Salman became creditor (a liability)	1st Jan. 1991	Purchases account	Dr. 10,000	
		Salman account		10,000
		(Goods purchased on credit basis.)		

Transaction No. 2

Acceptance given to Mr. Salman instead of paying him cash. The entry is:

			Rs.	Rs.
Decrease in one liability and increase in a new liability	1.1.1991	Salman account	Dr. 10,000	
		Bill Payable account		10,000
		(Acceptance given to Salman for 90 days.)		

Transaction No. 3

Acceptance is met (paid) on the due date. The entry is:

			Rs.	Rs.
Decrease in liability and decrease in cash (Asset)	4.4.1991	Bill Payable account	Dr. 10,000	
		Cash account		10,000
		(On maturity, acceptance is paid in cash.)		

In the above illustration, we just discussed only one use of a bill of exchange i.e., the drawer retained the bill with himself till due date and then presented to the acceptor, who honoured the bill (Paid cash to the drawer). Every drawer or receiver of a bill has three options for him. (a) He can retain the bill till the due date, (b) he can endorse the bill to one of his creditors in settlement of his own debts., (c) he can discount it (If he is in need of money and cannot wait till due date) with his banker.

In the same way every acceptor has four possibilities, (a) he may pay the amount of bill on presentation, (b) he may refuse to honour the bill, (c) he may request the drawer to renew the bill (extending the period of payment), (d) he may get the bill retired. (paying his obligation before due date).

For the drawer the above mentioned options are explained below:

Suppose, drawer received a bill from the acceptor

B/R

(1) The first option for the drawer is to retain this bill in his own possession. On the due date, he will present the document (bill) to the acceptor and receive cash from him.

Discounting of a Bill of Exchange.

(2) The second option for the drawer is to discount the bill with his bank at a certain rate of discount. In this case the bank will take the possession of the bill and on the maturity date, will present the bill to the acceptor and receive full amount of the bill.

Endorsement of a bill of exchange

(3) The third option opens to the drawer is to endorse the bill in favour of one of his creditors (from whom he has already purchased goods on credit) for the settlement of his own debts. Under this case, his creditor will take the possession of the bill. On maturity he will now present this bill to the acceptor and acceptor will pay cash to him.

(4) This option is, in fact, a part of the first one. Under this possibility, the bill is sent to the bank for collection purposes. This is not discount of a bill.

In the above Figure 5, we have discussed all the options. Now we will see what journal entries are passed in books of different parties under these four conditions. It will be explained with the help of illustrations.

CASE NO. 1:

When a bill is retained by the drawer or the receiver with himself till the due date.

ILLUSTRATION NO. 1 SL

A sold goods to B valued Rs. 10,000 on credit basis on 1st Jan. 1991. On the same date, A drew a bill of exchange on B for Rs. 10,000 at three months. It was accepted by B and returned to A. On maturity, B honoured his acceptance.

Req: **Pass the journal entries in books of A and B.**

Solution:

A's Journal

Date	Details	L/R	Debit Rs.	Credit Rs.
1.1.1991	B Account Dr.		10,000	
	Sales Account			10,000
	Goods sold for credit.			
1.1.1991	Bill Receivable Account Dr.		10,000	
	B Account			10,000
	Acceptance received from B.			
4.4.1991	Cash Account Dr.		10,000	
	Bill Receivable account			10,000
	Acceptance received in cash on presentation.			

B became debtor (Asset).

B paid his debts by giving acceptance.

Increase in cash (Asset). Decrease in B/R (asset).

Further Explanation of Journal entries passed.

(1) Journal Entry:
This journal entry indicates that B has become debtor for Rs. 10,000.

(2) It indicates that B settled his account by giving acceptance of Rs. 10,000.

(3) It shows, on the due date, acceptance was converted into cash.
Due date = 1st April + 3 grace days = 4th April.

Generally three concessional days are given to acceptor.

B's Journal

Date	Details	L/R	Debit Rs.	Credit Rs.
1.1.1991	Purchase Account Dr.		10,000	
	A's Account			10,000
	Goods purchased for 3 month credit.			
1.1.1991	A Account . Dr.		10,000	
	Bill Payable Account			10,000
	Acceptance is given instead of paying cash.			
4.4.1991	Bill Payable Account Dr.		10,000	
	Cash Account			10,000
	Acceptance honoured on presentation.			

Increase in liability (A).

Decrease in liability (A) and increase in new liability (B/P).

Decrease in liability (B/P) and decrease in cash.

DISCOUNTING OF A BILL OF EXCHANGE: ANOTHER USE OF BILL:

When the acceptor of the bill is a reputable person the bill is as good as money, and any bank will discount it.

If the drawer of the bill does not want to wait till the due date and is in need of money, he may sell his bill to a bank at a certain rate of discount. The bill will be endorsed by the drawer with a signed and dated order to pay the bank. The bank will become then the holder and owner of the bill. After getting the bill, the bank will pay cash to the drawer equal to the face value less interest or discount at an agreed rate for the number of days it has to run. This process is known as **discounting of a bill.**

For example: A drawer has a bill for Rs. 10,000. He discounted this bill with his banker two months before its due date at 15% p.a rate of discount. Discount will be calculated as,

$$10{,}000 \times \frac{15}{100} \times \frac{2}{12} = 250$$

Thus the drawer will receive cash worth Rs. 9750 and will bear a loss of Rs. 250.

The bank will keep this bill in its possession till the due date. On maturity the bank will present the bill to the acceptor and will receive cash from him (if the bill is honoured). In case, the acceptor does not make payment to the bank, then the drawer or any person who has discounted the bill will have to take this liability (he will pay cash to the bank).

Discounted bill is a contingent liability of the drawer.

Therefore, we see that until a bill is honoured on the due date, there is always a chance that the drawer will become liable on the bill. This is called a **contingent liability** -- a liability that will only arise if a certain event occurs -- the acceptor does not honour the bill.

DISCOUNTING OF A BILL

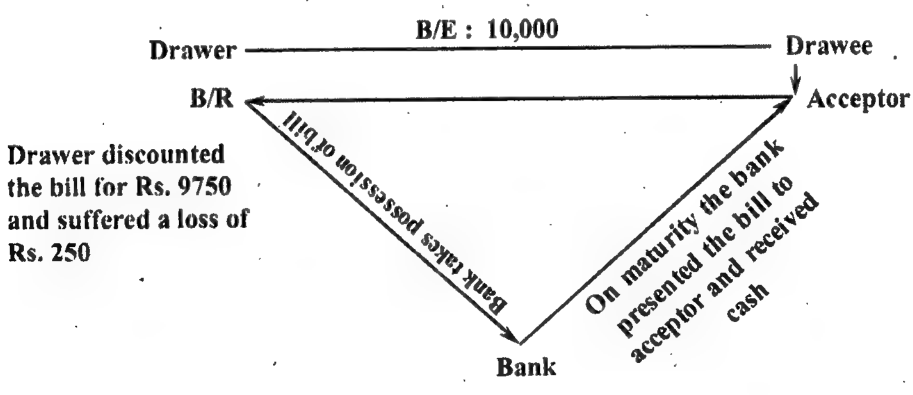


Figure 5

When a bill is discounted by the holder, the following entries are passed in the books of drawer, drawee and bank:

When the bill is drawn by the drawer (A) and is accepted by the drawee (B).

Drawer's Journal	Drawee's Journal
B/R A/c........ xxxx B. A/c.............xxx. Acceptance received.	A A/c ... Dr. xxxx B/P account........xxx. Acceptance given.
When a bill is discounted at a banks: Bank A/C.............................xxx Discount A/C ....xxx B/R A/C ....xxx Bill discounted at bank.	No, journal entry, as the acceptor is not concerned.

The entry for discounting of a bill in drawer's journal shows increase in drawer's bank balance at present value (face value - discount given), increase in a loss (discount given) and decrease in an asset (B/R).

The entry in the journal of the bank will be as under:

Bank's Journal

B/R A/C..Dr.	with face value of bill.
Drawer A/C..	Present value of bill
Discount A/C.......................................	Discount received.

This journal entry indicates, increase in asset (B/R) in the bank, increase in a liability (the amount transferred to drawer's A/C) and increase in a revenue for the bank.

When the bank presented the bill to the acceptor on maturity date and the acceptor met his obligation, the following entries are passed:

Drawer's Journal	Drawee's Journal	Bank's Journal
No entry as he has already received the money from the bank.	B/P A/C............Dr.xxx Cash A/C..........xx Acceptance honoured and cash paid to bank on presentation of the bill.	Cash A/C ....Dr.xx B/R A/C..............xx Cash received from acceptor equal to full value of the bill.

ILLUSTRATION NO. 2 SL

Amjad sold goods to Sohail worth Rs. 5,000 on 1st January, 1991. He drew a bill on Sohail for Rs. 5,000 on the same date, payable after 3 months. Sohail accepted the bill and returned it to Amjad. On 4th Feb., 1991, Amjad discounted the bill at his bank at 15% per annum. On the due date the bill was honoured by the acceptor. Show entries in books of Amjad, Sohail and the bank.

Solution:

Amjad's Journal

			Rs.	Rs.
1.1.1991	Sohail Account Dr.		5,000	
	Sales Account			5,000
	Goods sold for 90 days credit.			
1.1.1991	Bill Receivable account Dr.			
	Sohail Account		5,000	
	Acceptance received at 3 months.			5,000
	Bank Account Dr.		4,875	
4.2.1991	Discount Account Dr.		125	
	Bill Receivable Account			5,000
	The bill was discounted at 15% p.a. and bank balance increased equal to Rs. 4,875.			

$5000 \times \frac{15}{100} \times \frac{2}{12}$

Sohail's Journal

			Rs.	Rs.
1.1.1991	Purchase Account Dr.		5,000	
	Amjad Account			5,000
	Goods purchased for 90 days credit.			
1.1.1991	Amjad Dr.		5,000	
	Bill payable Account			5,000
	Acceptance given at 3 months.			
4.4.1991	Bill Payable account Dr.		5,000	
	Cash Account			5,000
	Acceptance paid on presentation by the bank.			

Bank's Journal

4.2.1991	Bill Receivable Account Dr.		5,000	
	Amjad Account			4,875
	Discount Account			125
	Bill was discounted and the present value (4,875) was transferred to Amjad account.			
4.4.1991	Cash Account Dr.		5,000	
	Bill Receivable Account			5,000
	Received the full value of bill from acceptor on the due date.			

THIRD OPTION OR USE OF BILL: ENDORSEMENT:

The drawer or holder of the bill may endorse (transfer) the bill in favour of his creditor for the clearance of his own debts. A bill of exchange is a "negotiable instrument" i.e. a document which is transferable by delivery without notice to the party liable (drawee).

If the holder of the bill puts his signature on the back of the bill with a view to transfer the property contained in it (right to receive money from the acceptor), then he becomes **Endorser,** and the person to whom the bill is transferred will become **endorsee**. This procedure by which a bill is transferred from one person to another person for the settlement of debts is called '***Endorsement***'.

For example: A drews a bill on **B** for Rs. 5,000 which is accepted by B at three months. A bought goods from C worth Rs. 7000 on credit basis. Now C is creditor of A for Rs. 7000. A endorsed the bill in favour of his creditor C for paying his debts up to the extent of Rs. 5,000. Thus C is now creditor of A up to the extent of Rs. 2000 only: i.e. 7,000-5000=2000.

Now C is the holder of the bill of exchange, which he has got from A. Being holder of the bill, C has all the four options before him. He may retain the bill till the due date. On due date, he will present the bill to the acceptor and receive cash from him.

One important point that we should remember is, whenever a bill is discounted or endorsed, it will not be considered as the property (asset) of the person who has discounted or endorsed it and the Bill Receivable account is written off (neutralized) as it is no longer receivable. However, there is one possibility in which he can still be affected by the bill i.e. the person liable primarily to the bill is acceptor, who has accepted the obligation to pay. Suppose he does not honour the bill on the due date, then the person who endorsed this bill will be liable to pay. So, this is a contingent liability of the endorser until the bill is honoured by the acceptor.

An endorsed bill is contingent liability of the endorser.

For example, on maturity date, C presented the bill to the acceptor B but he refused to make payment. C will receive the amount from the endorser A. So, A has to take up the liability and in turn A will receive the amount from B.

When a bill is endorsed the following entries are made in the books of endorser and endorsee as the drawee will remain unaffected.

Endorser's Journal (A)	Endorsee's Journal (C)
When a bill is endorsed Endorsee's A/C........... xxx Bill Receivable...................xxx	Bill Receivable A/c .... xxx Endorser's A/c xxx
No journal entry.	On the due date, the bill is presented to the acceptor and cash is received from him, the entry is: Cash A/c ....Dr.xxx Bill Receivable A/c xxx

ILLUSTRATION NO. 3 SL

Asif sold goods to Rauf valued Rs. 10,000 on 1st January 1991 for a credit of 2 months. Asif drew and Rauf accepted a bill for Rs. 10,000 at two months on the same date. Farooq was creditor of Asif for Rs. 10,000. Asif settled his account by endorsing the bill to Farooq on 2nd Jan. 1991. On maturity, Rauf met his acceptance. Give journal entries in the books of Asif, Farooq and Rauf.

Solution:

Asif's Journal

	Date			Debit Rs.	Credit Rs.
	1.1.1991	Rauf Account Dr.		10,000	
		Sales Account			10,000
		Goods sold to Rauf for two months credit.			
	1.1.1991	Bill Receivable Account...............Dr.		10,000	
		Rauf Account...........................			10,000
		Acceptance received at two months.			
Decrease in liability (Farooq) and decrease in asset (B/R).	2.1.1991	Farooq Account Dr.		10,000	
		Bill Receivable Account			10,000
		Bill was endorsed to Farooq for the settlement of debts. Farooq's account is now showing nil balance.			

Farooq's Journal

				Dr. Rs.	Cr. Rs.
Increase in Asset (B/R) and decrease in (asset) debtor.	2.1.1991	Bill Receivable Account Dr.		10,000	
		Asif Account			10,000
		Received a bill from Asif in settlement of his debts.			
	4.3.1991	Cash Account Dr.		10,000	
		Bill Receivable Account			10,000
		Received cash from acceptor on presentation of the bill.			

Rauf's Journal

				Dr Rs.	Cr Rs.
	1.1.1991	Purchases Account Dr.		10,000	
		Asif Account			10,000
		Goods purchased on credit basis			
	1.1.1991	Asif Account Dr.		10,000	
		Bill Payable Account			10,000
		Acceptance given payable after two months.			
Bill is honoured by the acceptor.	4.3.1991	Bill payable Account Dr.		10,000	
		Cash Account			10,000
		Acceptance met, and cash paid to the holder of the bill (Farooq).			

Bill sent to the Bank for Collection: (fourth option)

Safety collection

If a businessman has numerous bills that he got from various debtors he may send these bills to his banker for collection purposes. It should be remembered that, this is not discounting of bill, the bills are sent for safety and collection purposes. The band keeps the bill in its custody till the due date and on the due dates, the banks will present the bills to various acceptors. After collecting the amount, the bank transfers the amount to the account of its customer (by giving credit to his account). The bank charges some nominal fee from the customer for services he rendered. This is an expense for the customer and revenue for the bank.

The drawer opens a temporary account in his books, when the bill is sent to the bank for collection. The name of the account is "Bank for collection account." The bill is transferred to this account and the following entry is passed in journal of Drawer.

Bank for collection account.........Dr. xx.

Bill Receivable account.........................xx

When the bill is collected by the bank on the due date and intimation is received from the bank, the following entry is made in drawer's books:

Bank account.......Dr. xx

Bank for collection account.......xx.

Some fees is charged by the bank for the services it provided. The entry in drawer's journal is:

Bank charges account.......Dr. xx — Increase in expenses

Bank account............ xx — Decrease in bank balance.

The following entries are passed in books of the bank.

(1) When the bill is received from the drawer for collection, no journal entry is passed.

(2) When the bill is collected from the acceptor, the entry is:

Cash account..................Dr.xx {with full value of the bill}

Drawers account.................xx

---

(3) A separate entry is passed for collection charges, i.e.

Drawer's A/C......................Dr. xxx — Reduction in drawer's A/C

Collection charges account......xx — Increase in revenue.

In the books of the acceptor, the same entry is passed as in previous cases: i.e.

Bill Payable A/C .... Dr. xx

Cash A/C xx

ILLUSTRATION NO. 4 SL.

Imran sold goods to Irfan for Rs. 5,000 on credit on 1st July, 1991. On the same date, Imran drew two bills on Irfan for Rs. 3,000 and Rs. 2,000 at two months and three months respectively. On 4th July the first bill was discounted at the bank at 15% p.a. On 6th July, the other bill was sent to the bank for collection. On the due date, both bills were honoured and the bank deducted Rs. 20 as bank charges. Give journal entries in the books of Imran, Irfan and the bank.

Solution:

Imran's Journal

	Date	Particulars	L/R	Dr.	Cr.
	1.7.1991	Irfan Account Dr.		5,000	
		Sales Account.. . .			5,000
		Goods sold on credit basis.			
	1.7.1991	Bill Receivable Account Dr.		3,000	
		Irfan Account			3,000
		Acceptance received at two months			
	1.7.1991	Bill Receivable Account Dr.		2,000	
		Irfan Account			2,000
		Acceptance received at three months.			
	4.7.1991	Bank Account Dr.		2,925	
$3000 \times \frac{15}{100} \times \frac{2}{12} = 75$		Discount Account Dr.		75	
		Bill receivable Account			3,000
		Bill discounted at 15% p. a.			
Temporary A/C opened.	6.7.1991	Bank for Collection Account Dr.		2,000	
		Bank Receivable Account			2,000
		Bill sent to bank for collection.			
Increase in the bank balance and temporary A/c closed.	4.10.1991	Bank Account Dr.		2,000	
		Bank for Collection Account			2,000
		Bill collected by bank from acceptor on the due date.			
Increase in expense and decrease in bank balance.	4.10.1991	Bank charges Account Dr.		20	
		Bank Account			20
		Amount deducted by the bank as collection charges.			

Irfan's Journal

	Date	Particulars		Dr.	Cr.
	1.7.1991	Purchase Account Dr. Imran Account Goods purchased on credit.		5,000	5,000
	1.7.1991	Imran Account Dr. Bill Payable Account Acceptance given at two months.		3,000	3,000
	1.7.1991	Imran Account Dr. Bill Payable Account Acceptance given at 3 months.		2,000	2,000
Acceptance met after two months.	4.9.1991	Bill Payable Account Dr. Cash Account Acceptance paid on presentation.		3,000	3,000
Acceptance met after 3 months.	4.10.1991	Bill Payable Account Dr. Cash Account Acceptance met at maturity on presentation.		2,000	2,000

Banker's Journal

	Date	Particulars		Dr.	Cr.
	4.7.1991	Bill Receivable Account Dr Imran Account Discount Account Bill discount at 15% p.a		3,000	2,925 75
	6.7.1991	No Journal entry is passed when the bill is received from the customer for collection.			
On maturity acceptor honoured the bill.	4.9.1991	Cash Account Dr. Bill Receivable Account Discount bill presented to the acceptor and cash received.		3,000	3,000
	4.10.1991	Cash Account Dr. Imran Account Amount of the bill collected from the acceptor on behalf of the customer (Imran).		2,000	2,000
	4.10.1991	Imran Account Dr. Collection charges Account Charges deducted from Imran's account.		20	20

DISHONOUR OF A BILL OF EXCHANGE:

We have discussed all options or possibilities in which a bill of exchange is presented to the acceptor on the due date and he readily honours it. Now let us see what happens when a bill is not honoured by the acceptor on the due date (Cash is not paid to the holder of the bill)? A bill of exchange is said to be **dishonoured** when its acceptor refuses to pay the amount of the bill to the holder of the bill on its maturity. The bill then becomes useless and the party from whom it has been received will be liable to pay for the amount. It is very important to know that, when a bill is dishonoured, in whose possession it was? Because when a bill is dishonoured, all the parties involved are affected and books of accounts of all the parties have to be adjusted. For example, A draws a bill of Rs. 5,000 on B and B accepts it and returns it to A. A retains the bill in his possession till the due date. On the due date the bill is not honoured by the acceptor. We can see, there are two parties involved whose books are to be adjusted. If suppose, A has discounted or endorsed the bill, then there are three parties involved and books of accounts of all the parties are affected.

NOTING CHARGES:

When a bill is dishonoured, the holder of the bill, (drawer, banker, endorsee or any other party) in order to make a strong ground for drawing legal proceeding against the acceptor may get the official recognition that the bill has been dishonoured. He goes to an official called Notary Public, and gives the bill to him. The Notary Public will present the bill for payment again to the acceptor and if the money is received he will hand over the money to the original party. But if the bill is again dishonoured, the notary public will note the fact of dishonour and the reasons of dishonour on the bill and will give the bill back to the holder of the bill. It is now a strong evidence against the acceptor, in case, if the case is filed in the Court.

For this service, the notary public will charge a small fee obviously from the holder of the bill. This fee is known as '**noting charges**' and is always recoverable from the party which is responsible for dishonour (the acceptor).

The students should remember that noting charges are not the expenses of any party involved. They are always expenses of the acceptor, in whose books they will be debited.

GENERALLY WHO PAYS NOTING CHARGES:

(a)	If the bill is retained by the drawer	= The drawer will pay.
(b)	If the bill has been discounted	= The bank will pay.
(c)	If the bill has been endorsed to the endorsee	= The endorsee will pay.
(d)	If the endorsee has endorsed the bill to his creditor (a new endorsee)	= The new endorsee will pay.

But the new endorsee will recover the amount of noting charges from first endorsee, the first endorsee from the drawer and ultimately the drawer from the acceptor (Being an expense of acceptor). The dishonour of the bill of exchange and noting charges paid are explained in Figure. 6

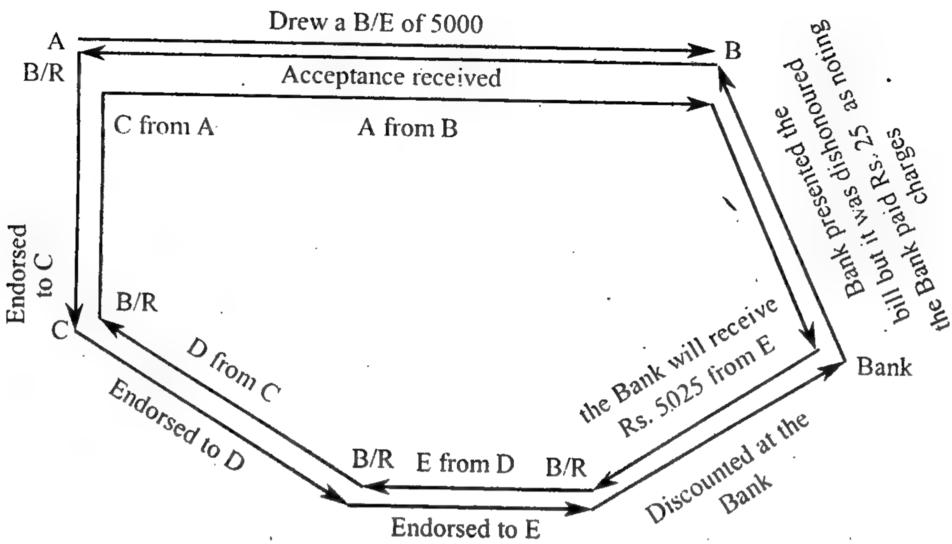


Figure 6

It is very much clear from the Figure 6, that on maturity date, the holder of the bill was the bank. The bank presented the bill to the acceptor but it was dishonoured and the bank paid Rs. 25 as noting charges.

For bank, E is liable from whom it got the bill, for E, D is liable, for D, C is liable, for C, A is liable and for A, B is liable to pay. Now the bank will not only recover Rs. 5,000 from E, it will also recover Rs. 25 for noting charges i.e. Rs. 5,025. E will recover Rs. 5,025 from D, D will recover Rs. 5,025 from C, C from A and A from B Rs. 5,025.

Accounting treatment in books of the drawer, acceptor and other parties, when a bill is dishonoured.

IN THE BOOKS OF DRAWER:

When a bill is retained by the drawer,

(1) (a) Acceptor account........Dr.xx } with full amount of bill.
Bill Receivable account }

(b) If noting charges have been paid by the drawer the holder.

Acceptor A/C ....Dr.xx		amount of bill + amount of noting charges
Bill Receivable A/C	xx	face value of the bill.
Cash A/C	xx	amount of noting charges (decrease in cash).

(2) When a bill is discounted with the bank:

(a) Acceptor A/C.........Dr.xx } with amount of bill.
Bank A/C.................. xx }

(b) If noting charges are paid by the bank (holder).

Acceptor A/C......... Dr.xx } With amount of bill + the amount of noting charges.
Bank A/C.....................xx }

(3) If a bill is endorsed in favour of creditor (Endorsee):

(a) Acceptor A/C ....Dr.xx
    Endorsee A/C................xx } with amount of bill.

(b) If noting charges are paid by the Endorsee (holder).

Acceptor A/C ....Dr.xx
    Endorsee A/C................xx } with amount of the bill + the amount of noting charges.

(4) If the bill is sent to the bank for collection.

(a) Acceptor A/C............Dr.xx
    Bank for collection A/c...xx } with amount of the bill.

(b) When noting charges were paid by the bank (holder).

Acceptor A/C ....Dr.xx {with amount of the bill + the amount of N.C.

Bank for Collection A/c xx {face value

Bank A/C......................xx {amount of noting charges).

ENTRIES IN BOOKS OF THE ACCEPTOR:

(a) Bill Payable A/C.......Dr.xx (with amount of the bill).

Drawer's A/C..................xx

(b) Bill Payable A/C.......Dr.xx (with face value of the bill)

Noting charges A/C.....xx (amount of noting charges).

Drawer A/C.................xx (with amount of the bill + the amount of noting charges).

It must be noted that noting charges a/c is not debited in books of drawer as it is not an expense of the drawer. It is only debited in books of the acceptor.

NOTE:

Under the above cases we have learnt that in case of dishonour of a bill, the account of the acceptor is always debited in books of the drawer and the account.

(a) Credited is B/R, if the bill is retained by the drawer.

Credited is Bank A/c if the bill is discounted.

Credited is Endorsee A/c if the bill is endorsed.

Credited is Bank for collection A/c, if the bill is sent to the bank for collection.

On the other hand, in the books of the acceptor, the account debited is Bill payable and account credited is drawer's a/c in all the cases, when a bill is dishonoured.

The journal entries in the books of drawer on dishonour of a bill are summarised in the following way: Suppose A drew and B accepted a bill for Rs. 1,000 and A discounted it for Rs. 975.

(1) Drawer's Journal	(2) Drawer's Journal	(3) Drawer's Journal	(4) Drawer's Journal
When bill is drawn and accepted B/R A/c 1,000 B A/c 1,000	when bill is drawn and accepted B/R A/c 1,000 B A/c 1,000	when bill is drawn and accepted B/R A/c 1,000 B A/c 1,000	when bill is drawn and accepted B/R A/c 1,000 B A/c 1,000
Bill is retained No further entry	Bill is discounted entry is, Bank A/c 975 Discount A/c 25 B/R A/c 1,000	Bill is endorsed to C (Creditor) entry is C A/c 1,000 B/R A/c 1,000	Bill is sent to bank for collection, entry is, Bank for collection A/c 1,000 B/R A/c 1,000
On dishonour B (Acceptor) 1,000 B/R A/c 1,000	On dishonour B (acceptor) 1,000 Bank A/c 1,000	On dishonour B (acceptor) 1,000 C A/c 1,000	On dishonour B(acceptor) 1,000 Bank for Collection A/c 1,000

ILLUSTRATION NO. 5

On 1st January 1991, Amjad sold goods to Shakeel for Rs. 5,000 on credit basis. On the same date Amjad drew a bill for Rs. 5,000 on Shakeel at two months. Shakeel accepted the bill and returned it to Amjad. On the due date Shakeel could not honour his acceptance. Give entries in journals of Amjad and Shakeel.

Solution:

Amjad's Journal

Shakeel became a debtor.	1.1.1991	Shakeel Account Dr. Sales Account Goods sold on credit.		5,000	5,000
Shakeel is not now a debtor.	1.1.1991	Bill Receivable Account Dr. Shakeel Account Acceptance received at two months.		5,000	5,000
Shakeel again became debtor.	4.3.1991	Shakeel Account Dr. Bill Receivable Account Bill is dishonoured on the due date.		5,000	5,000

NOTE:

When the goods were sold to Shakeel, he became a debtor for Rs. 5,000. Then he paid his debts by giving acceptance (B/R) to Amjad. But when he did not honour his acceptance on the due date, he again became a debtor of Amjad. (Amount is still due from him).

Shakeel's Journal

	Date	Particulars		L.F.	Dr.	Cr.
Amjad became Creditor.	1.1.1991	Purchase Account	Dr.		5,000	
		Amjad Account				5,000
		Goods purchased on credit.				
Amjad is not creditor now.	1.1.1991	Amjad Account	Dr.		5,000	
		Bill Payable Account				5,000
		Acceptance given at two months.				
Amjad again became creditor.	4.3.1991	Bill Payable Account	Dr.		5,000	
		Amjad Account				5,000
		Acceptance not honoured on maturity.				

In the above illustration, the drawer (Amjad) has not got the bill noted by the notary public and so no noting charges were paid by him.

Suppose if he also paid Rs. 20 as noting charges, then a further entry will have to be passed both in the books of Amjad as well as in the books of Shakeel.

In Amjad's Journal

	Date	Particulars		L.F.	Dr.	Cr.
Being not an expense of Amjad.	4.3.1991	Shakeel Account	Dr.		20	
		Cash Account				20
		Cash paid as noting charges on behalf of the acceptor.				

In Shakeel's Journal

Date	Particulars		L.F.	Dr.	Cr.
4.3.1991	Noting Charges Account	Dr.		20	
	Amjad Account				20
	Noting charges paid by the drawer (Amjad).				

ILLUSTRATION NO. 6 SL

Salim sold goods to Kalim for Rs. 5,000 on 1st Sep. 1991 on credit. Salim drew and Kalim accepted a bill for Rs. 5,000 at 3 months. On 4th Sep. 1991, Salim discounted the bill with his banker at 15% p.a. On maturity, when bank approached the acceptor, he refused to honour the bill. Bank got the bill noted and paid Rs. 25 as noting charges. Give entries in the books of Salim, Kalim and the Bank.

Solution:

Salim's Journal

$5000 \times \frac{15}{100} \times \frac{3}{12}$

Kalim became debtor for Rs. 5,025 and bank deducted Rs. 5,025 from Salim's account.

Date	Particulars		L.F.	Dr.	Cr.
1.9.1991	Kalim Account	Dr.		5,000	
	Sales account				5,000
	Goods sold on credit.				
1.9.1991	Bill Receivable Account	Dr.		5,000	
	Kalim Account				5,000
	Acceptance received at 3 months.				
4.9.1991	Bank Account	Dr.		4812.50	
	Discount Account	Dr.		187.50	
	Bill Receivable Account				5,000
	Bill discounted at 15% p.a.				
4.12.1991	Kalim Account	Dr.		5,025	
	Bank Account				5,025
	Bill dishonoured when presented to the acceptor by bank. Bank paid Rs. 25 noting charges.				

NOTE:

When the bill was dishonoured, being the holder of the bill, the bank paid Rs. 25 as noting charges, so the bank deducted not only Rs. 5000 from Salim account but Rs. 5,025, Rs. 25 as noting charges. Salim will also recover Rs. 5,025 from the acceptor (Kalim).

Kalim's Journal

Salim is now creditor for Rs. 5000+25 =5025

Date	Particulars		L.F.	Dr.	Cr.
1.9.1991	Purchase account	Dr.		5,000	
	Salim account				5,000
	Goods bought on credit.				
1.9.1991	Salim account	Dr.		5,000	
	Bill Payable account				5,000
	Acceptance given for 3 months.				
4.12.1991	Bill Payable account	Dr.		5,000	
	Salim account				5,000
	Bill dishonoured on maturity.				
4.12.1991	Noting charges Account	Dr.		25	
	Salim Account				25
	Amount of noting charges claimed by the drawer.				

Bank's Journal

Present value = face value - discount.	4.9.1991	Bill Receivable Account Dr. Salim Account Discount Account Bill received from Salim and amount (present value) transferred to his account.		5,000	 4812.50 187.50
	4.12.1991	Salim Account Dr. Bill Receivable Account Cash Account Bill dishonoured by the acceptor and total amount (amount of bill plus noting charges) deducted from Salim's account.		5,025	 5,000 25

ILLUSTRATION NO. 7 SL

P sold goods to Q for Rs. 2,000 on credit basis. P drew and Q accepted a bill at 3 months. R was a creditor of P. P settled his debts by endorsing him Q's acceptance. On the due date when R presented the bill to Q, he dishonoured the bill. So being holder of the bill R paid Rs. 20 as noting charges. Show the journal entries in the books of P, Q and R.

Solution:

P's Journal

		Q Account Dr. Sales Account Goods sold for credit.		2,000	 2,000
		Bill Receivable account Dr. Q Account Acceptance received at 3 months.		2,000	 2,000
Creditor R is paid by B/R.		R Account Dr. Bill Receivable Account Bill endorsed to a creditor.		2,000	 2,000
Q became debtor and R became again creditor.		Q Account Dr. R Account Bill dishonoured and noting charges paid by R.		2,020	 2,020

Q's Journal

	Purchase Account Dr. P Account Goods purchased on credit.		2,000	2,000
	P Account Dr. Bill Payable Account Acceptance given at 3 months.		2,000	2,000
	Bill Payable Account Dr. Noting charges Account Dr. P Account Acceptance dishonoured and noting charges claimed by P.		2,000 20	2,000

R's Journal

P paid his debts by B/R.	Bill Receivable Account Dr. P Account Bill received from the debtor in settlement of his debts.		2,000	2,000
P became debtor.	P Account Dr. Bill Receivable Account Bill dishonoured when presented to the acceptor.		2,000	2,000
	P Account Dr. Cash Account Noting charges paid on behalf of P or claimed from P.		20	20

NOTE:

Instead of last two entries, a compound entry may be passed. That entry is:

P account	2,020	
Bill Receivable account		2,000
Cash account		20

ILLUSTRATION NO. 8 52

On 1st November, 1991, A sold goods to B for Rs. 1,000 on credit basis. A then drew and B accepted a bill at two months. A sent the bill to his banker for collection. On the due date the bill was duly presented to the acceptor but he could not meet his acceptance. The bank paid Rs. 25 as noting charges on behalf of A. The bank also charges Rs. 5 as collection charges.

Pass the journal entries in the books of A, B and the bank.

Solution:

A's Journal

			Dr.	Cr.
1.11.1991	B Account Dr. Sales Account Goods sold on credit.		1,000	1,000
1.11.1991	Bill Receivable Account Dr. B Account Acceptance received at 2 months.		1,000	1,000
1.11.1991	Bank for Collection Account Dr. Bill Receivable Account Bill sent for collection.		1,000	1,000
4.1.1992	B Account Dr. Bank for Collection Account Bill dishonoured on maturity.		1,000	1,000
4.1.1992	B Account Dr. Bank Account Noting charges paid by bank recoverable from the acceptor.		25	25
4.1.1992	Bank Charges Account Dr. Bank Account Bank charges paid.		5	5

Amount due from B is Rs. 1,025.

Though bill is dishonoured but bank charged its fee.

B's Journal

			Dr.	Cr.
1.11.1991	Purchase Account Dr. A Account Goods purchased on credit.		1,000	1,000
1.11.1991	A Account Dr. Bill Payable Account Acceptance given at 2 months.		1,000	1,000
4.1.1992	Bill Payable Account Dr. A Account Bill is not honoured.		1,000	1,000
4.1.1992	Noting Charges Account Dr. A Account Noting charges paid and claimed by A.		25	25

Banker's Journal

1.11.1991	Bank passed no entry when the bill is received for collection, so no entry is required when bill is dishonoured.			
4.1.1992	A Account Dr.		25	
	Cash Account			25
	Noting charges paid on behalf of his customer A.			
4.1.1992	A Account Dr.		5	
	Collection Charges Account			5
	Charges deducted from A's account.			

ILLUSTRATION NO. 9 SL.

On 1st January, 1991, X sold goods to Y worth Rs. 10,000 on credit basis. X drew on Y four bills of Rs. 2,500 each at 2 months, 3 months, 4 months and five months respectively. X retained the first bill till the due date. On 4th January, he discounted the second bill with his bank at 15% p.a. He endorsed the third bill in favour of his creditor Z on 6th January. The fourth bill, he sent to the bank for collection on 7th January, 1991. All the bills were presented to the acceptor for payment at their respective due dates but he could not honour even one bill (all the bills were dishonoured).

Pass the journal entries in the books of X.

Solution:

X's Journal

			Rs.	Rs.
	1.1.91	Y Account	10,000	
		Sales Account		10,000
		Goods sold on credit.		
1st Bill	1.1.91	B/R A/C	2,500	
		Y Account		2,500
		Acceptance received at 2 months.		
2nd Bill	1.1.91	B/R A/c	2,500	
		Y Account		2,500
		Acceptance received at 3 months.		
3rd Bill	1.1.91	B/R A/C	2,500	
		Y Account		2,500
		Acceptance received at 4 months.		
4th Bill	1.1.91	B/R A/c	2,500	
		Y Account		2,500
		Acceptance received at 5 months.		

X's Journal

Entries when bills returned dishonoured:

4.3.91	Y Account	2,500	
	B/R A/C		2,500
	1st bill dishonoured on maturity.		

2nd Bill discounted	4.1.91	Bank Account 2406.25 Discount Account 93.75 B/R Account 2,500 Bill discounted at 15% p.a	4.4.91	Y Account 2,500 Bank Account 2,500 2nd bill returned dishonoured.
Third Bill endorsed	6.1.91	Z Account 2,500 B/R A/c 2,500 Bill endorsed to the creditor.	4.5.91	Y Account 2,500 Z Account 2,500 Third bill dishonoured.
Fourth bill sent for collection	7.1.91	Bank for Collection Account 2500 B/R A/c 2500 Bill sent to the bank for collection.	4.6.91	Y Account 2,500 Bank for Collection A/c 2,500 Fourth bill dishonoured.

RENEWAL OF A BILL:

Sometimes, the acceptor of a bill finds himself unable to meet his acceptance on the due date. So he may approach the drawer of the bill before the maturity date arrives, to cancel the old bill and draw a new bill with extended date. The acceptor in this case will, of course, have to pay interest for the extended period. Thus the cancellation of the old bill before maturity in return for a new bill (which includes interest) for an extended period is called **'Renewal of a Bill'**. There are two more ways to renew a bill of exchange, (a) The acceptor pays interest in cash and a new bill is accepted equal to the amount of the old bill. (b) The acceptor pays a part of the amount of the bill in cash and accepts a new bill for the balance plus interest.

The renewal of the bill under different conditions is explained with the help of following examples:

(1) On 1st January, 1991 A (the creditor) draws a bill for Rs. 1,000 on his debtor B at 3 months. The due date of the bill is 4th April. On 31st March, the acceptor (B) approaches the drawer (A) and shows his inability to meet the bill. He requests the drawer to cancel the old bill and to draw on him a new bill for extended period. A agrees on the condition that he will charge Rs. 20 as interest. Thus a new bill is drawn for Rs. 1000 + 20 = 1020. The bill is accepted by B.

(2) On 31st March, before the due date of the same bill, B, the acceptor, approaches the drawer and shows his inability to meet the bill. He requests the drawer to cancel the old bill and to draw on him a new bill for an extended period. A agrees on this condition that he will charge Rs. 20 for interest. B pays Rs. 20 for interest at the same time and accepts a new bill at two months for Rs. 1,000.

(3) On 31st March, the acceptor (B) requests the drawer for the cancellation of the old bill. A agrees. B pays Rs. 500 in cash as a part of the amount of the old bill and accepts a fresh bill for Rs. 510 (including Rs. 10 for interest) at two months (for an extended period).

DIFFERENCE BETWEEN DISHONOUR AND RENEWAL OF A BILL

When a bill is duly presented by the holder to the acceptor on the due date and the acceptor refuses to meet the bill, this is a case of dishonour of the bill.

On the other hand, if the acceptor approaches the drawer himself and shows his inability to meet the bill and requests the drawer to cancel the old bill and to draw on him a new bill for an extended period, it will be a case of renewal of the bill.

JOURNAL ENTRIES WHEN A BILL IS RENEWED

We know that a bill of exchange is drawn by the creditor on the debtor. When a bill is accepted by the debtor, he will not be a debtor of the drawer. But when a bill is dishonoured or renewed, he becomes a debtor and the drawer becomes a creditor again. The following entries are passed in the books of the drawer and the drawee when a bill is renewed:

	Drawer's Journal	Drawee's Journal or Acceptor's Journal
	(a) Entries for cancellation of the old bill. (i) When the bill is in drawer's possession: Acceptor's account Dr. B/R account........................Cr. The old bill is canceled on acceptor's request. Acceptor becomes a debtor.	(a) Entry for cancellation of old bill is the same in all the cases B/P account Dr. Drawer's account Cr. The old bill is canceled for renewal.
Entry for the cancellation of the bill is passed according to the use of bill as in case of dishonour of the bill.	(ii) When the drawer has discounted the bill: Acceptor's Account Dr. Bank Account Cr. The old bill is canceled and amount was paid to the bank due to acceptor's inability.	" "
	(iii) When the drawer has endorsed the bill: Acceptor's Account Dr. Endorsees Account. Cr. The old bill is canceled and the endorsee becomes a creditor.	
Entries for cancellation and dishonour are the some but narration is different	(iv) When the bill is sent to the bank for collection: Acceptor's A/c Bank for collection A/c The old bill is canceled and the acceptor becomes a debtor.	" "
	Drawer's Journal	**Acceptor's Journal**
	(b) If the interest is received in cash: Cash A/c Interest A/c The interest on the renewed bill is received in cash.	(b) If the interest is paid in cash: Interest A/c Cash A/c The interest on the renewed bill is paid in cash.

(c) If the interest is not received in cash it is rather included in the new bill. Acceptor's A/c Interest A/c Interest due on renewed bill.	(c) If the interest is not paid in cash: Interest A/c Drawer's A/c Interest on renewed bill is payable.
(d) If a part of the amount of the old bill is received in cash: Cash A/c Acceptor's A/c Cash received as part payment.	(d) If a part payment is made: Drawer's A/c Cash A/c Cash paid as a part payment.
(e) When a new bill is drawn and accepted: B/R A/c Acceptor's A/c New acceptance received	(e) When new bill is accepted: Drawer's A/c B/P A/c New acceptance given.

NOTE :

There is no question of noting charges in renewal of the bill because a bill is renewed with the mutual consent of both the parties, i.e., the drawer and the acceptor.

ILLUSTRATION NO. 10

Zahid sold goods to Sharif worth Rs. 10,000 on 1st March, 1991. Sharif accepted a bill for three months drawn on him by Zahid on 1st March 1991. On 31st May, Sharif requested that the bill be renewed for a further period of 2 months. Zahid agreed provided 10 % interest p.a would be charged. Zahid then drew a new bill for the amount of original bill plus interest at 10% p.a for two months. Sharif accepted the new bill. On the due date the new bill was honoured. Give journal entries in books of Zahid and Sharif.

Solution:

Zahid's Journal			Sharif's Journal		
1.3.1991			1.3.1991		
Sharif	10,000		Purchase A/c	10,000	
Sales A/c		10,000	Zahid		10,000
Goods sold on credit			Goods purchased on credit		
1.3.91			1.3.91.		
B/R A/c	10,000		Zahid	10,000	
Sharif		10,000	B/P A/c		10,000
Acceptance received at 3 months			Acceptance given at 3 months		

Sharif becomes again a debtor	31.5.91 Sharif 10,000 B/R A/c 10,000 Old bill canceled on acceptor's request	31.5.91 B/P A/c 10,000 Zahid 10,000 Old bill canceled for renewal purpose
$10{,}000 \times \frac{10}{100} \times \frac{2}{12}$	31.5.91 Sharif 167 Interest A/c 167 Interest due from acceptor	31.5.91 Interest A/c 167 Zahid 167 Interest payable to drawer
New bill is drawn for	31.5.91 B/R A/c 10167 Sharif 10167 New acceptance received	31.5.91 Zahid 10,167 B/P A/c 10,167 New acceptance given
Rs. 10167 (10,000 + 167)	4.8.91 Cash A/c 10167 B/R A/c 10167 Cash received on maturity	4.8.91 B/P A/c 10,167 Cash A/c 10,167 Cash paid on maturity

ILLUSTRATION NO. 11 SL

X & Co. sold goods to Y & Co. for Rs. 20,000 and drew a bill for 3 months. Due to financial difficulties Y & Co. were not able to meet the bill on the due date, but agreed to pay only Rs. 6200 (Rs. 200 being interest) and asked X & Co. to draw a new bill for the balance due for one month. X & Co. agreed on this proposal. On the due date of the second bill Y & Co. honoured their acceptance. Give journal entries in the books of X & Co. and Y & Co.

Solution:

X & Co's Journal	Y & Co's Journal
Y & Co. A/c 20,000 Sales A/c 20,000 Goods sold on credit.	Purchase A/c 20,000 X & Co. A/c 20,000 Goods purchased on credit.
B/R A/c 20,000 Y & Co. 20,000 Acceptance received at 3 months.	X & Co. 20,000 B/P A/c 20,000 Acceptance given at 3 months.

Y & Co. became again debtor for Rs. 20,000	Y & Co. 20,000 B/R A/c 20,000 Old bill canceled on acceptor's request	B/P A/c 20,000 X & Co. 20,000 Old bill canceled for renewal purpose
	Cash A/c 200 Interest A/c 200 Interest received in cash	Interest A/c 200 Cash A/c 200 Interest paid in cash
Balance due from Y & Co. is 20,000- 6000 = 14000	Cash A/c 6,000 Y & Co. A/c 6,000 Cash received as a part of the amount of the old bill	X & Co. A/c 6000 Cash A/c 6000 Cash paid as a partial payment of the old bill
	B/R A/c 14,000 Y & Co. A/c 14,000 New acceptance received for the balance due from Y & Co. at one month	X & Co. 14,000 B/P A/c 14,000 Fresh acceptance given at one month for the balance due to X & Co.
	Cash A/c 14,000 B/R A/c 14,000 Cash received on maturity	B/P A/c 14,000 Cash A/c 14,000 Acceptance paid on maturity.

INSOLVENCY OF ONE PARTY:

When a person or party is declared by a court as insolvent or bankrupt he is considered to be unable to pay his liabilities. It means, the bills accepted by him will be naturally dishonoured. Therefore, when it is known that a person has become insolvent, entry for dishonour of the bill should be passed both in the books of the drawer and the acceptor (insolvent party).

When a person becomes insolvent, his private property, if he has any, is sold by a liquidator appointed by the court. Something may be received from his estate. Thus after passing entries for dishonour, we should prepare acceptor's account in the books of the creditor (drawer).

The acceptor's account in the books of the drawer will disclose the net amount due from him. Generally the amount received from the estate of insolvent party is less than the amount due from him. The unsatisfied balance is treated as bad debts and debited to 'Bad Debts' account in the books of the drawer and credited to 'Deficiency·Account' in books of the drawee.

On the insolvency of drawee, the following entries are passed in books of both the parties.

IN DRAWER'S BOOKS:

(a) Entry for dishonour in usual manner.

(b) Cash A/c {with actual amount received}

Bad debts A/c {unsatisfied amount}

Drawee's A/c {full amount}

Final dividend received and the balance treated as bad debts.

IN DRAWEE'S BOOKS:

(a) Entry for dishonour in usual way.

(b) Drawer's A/c (full amount)

Cash A/c {with actual amount paid}

Deficiency A/c { with amount unpaid}

Final claim paid to the creditor.

ILLUSTRATION NO. 12 SL.

Amjad sold goods to Sohail worth Rs. 10,000, taking a bill at 3 months, dated 1st July 1991. On 4th August he discounted the bill at 15% p.a with his banker. At maturity the bill was returned by the banker dishonoured and Amjad had to pay the bill. Sohail paid Rs. 4,000 to Amjad and accepted another bill at three months for Rs. 6,000 and 14% interest. But, before maturity, he became insolvent and only 50 paisa in a rupee was received as first and final dividend from his estate.

Pass journal entries in books of Amjad and Sohail.

Solution:

AMJAD'S JOURNAL

	Date	Particulars		Rs.	Rs.
	1.7.91	Sohail account..............................Dr. Sales account.............................. Goods sold on credit		10,000	10,000
	1.7.91	Bill Receivable account.................Dr. Sohail account............................ Acceptance received at 3 months		10,000	10,000
$10{,}000 \times \frac{15}{100} \times \frac{2}{12}$	4.8.91	Bank account................................Dr. Discount account..............................Dr. Bill Receivable account.............. Bill discounted at 15% two months before its maturity		9,750 250	10,000
Assume amount is paid to bank on acceptor's request.	4.10.91	Sohail account..............................Dr. Bank account............................. Old bill cancelled and amount paid to bank due to acceptor's inability		10,000	10,000
	4.10.91	Cash account ....Dr. Sohail account........................... Cash received from acceptor as a part payment		4,000	4,000
$6000 \times \frac{14}{100} \times \frac{3}{12}$	4.10.91	Sohail account..............................Dr. Interest account........................... Interest due from acceptor on the outstanding balance for 3 months		210	210

6000 +210

4.10.91	Bill Receivable account..................Dr. Sohail account............................. A new bill received at 3 months		6,210	 6,210
4.10.91	Sohail account...............................Dr. Bill Receivable account................ Bill dishonoured due to acceptor's insolvency		6,210	 6,210
4.10.91	Cash account.................................Dr. Bad debts account...........................Dr. Sohail account............................. Cash received from estate of acceptor and the balance written off as bad debts		3,105 3,105	 6,210

SOHAIL'S JOURNAL

1.7.91	Purchases account..........................Dr. Amjad account.............................. Goods purchased on credit		10,000	 10,000
1.7.91	Amjad account...............................Dr. Bill Payable account.................... Acceptance given at 3 months		10,000	 10,000
4.10.91	Bill Payable account......................Dr. Amjad account............................ Bill canceled for renewal purpose		10,000	 10,000
4.10.91	Amjad account..............................Dr. Cash account.............................. Cash paid as part payment		4,000	 4,000
4.10.91	Interest account.............................Dr. Amjad account............................. Interest payable to the drawer		210	 210
4.10.91	Amjad account.............................Dr. Bill Payable account.................... New acceptance given at 3 months		6,210	 6,210
	Bill Payable account....................Dr. Amjad account............................ Bill dishonoured due to insolvency		6,210	 6,210
	Amjad account.......... ....Dr. Cash account.............................. Deficiency account...................... Dividend of 50 paisa in a rupee paid and balance transferred to Def. A/c.		6,210	 3,105 3,105

RETIRING A BILL UNDER REBATE:

Sometimes the acceptor of a bill desires to meet the bill before its maturity if he has sufficient funds at his disposal. He may ask the holder of the bill to accept the payment before the due date. If the holder agrees to his proposal (obviously he welcomes it), he will withdraw the bill. Such a withdrawal is called 'retirement of a bill'. The holder generally allows the acceptor a rebate or discount for the unexpired period of the bill. This rebate or discount is an expense for the holder and a revenue for the acceptor of the bill. The accounting treatment is similar to cash discount.

When a bill is retired by an acceptor, the following entry is made in books of the holder.

Cash A/c	{with actual amount of cash received}
Rebate A/c	{Account of rebate allowed}
Bill Receivable A/c	{full amount of bill}

- In the books of the acceptor, the following entry is passed:

B/P A/c	(with full amount)
Cash account	(amount actually paid)
Rebate account	(rebate earned).

ILLUSTRATION NO. 13 SL

On 1st Jan. 1991, A sold goods to B worth Rs. 2,000 and drew a bill on B for Rs. 2000 at 3 months. One month before its maturity, B asked A that he wanted to make payment of the bill immediately, to which A agreed and also allowed him rebate of 6% p.a:

Pass entries in the books of A and B.

Solution:

A's Journal			B's Journal		
1.1.91			1.1.91		
B Account	2000		Purchase Account	2000	
Sales Account		2000	A Account		2,000
Goods sold on credit			Goods purchased on credit		
1.1.91			1.1.91		
Bill Receivable A/c	2000		A Account	2,000	
B Account		2000	Bill Payable A/c		2,000
Acceptance received at 3 months			Acceptance given payable after 3 months		
4.3.91			4.3.91		
Cash A/c	1,990		B/P A/c	2,000	
Rebate A/c	10		Cash A/c		1990
B/R A/c		2,000	Rebate A/c		10
Bill retired by the acceptor under a rebate of 6% p.a.			Bill retired under rebate one month before its maturity		

One month before due Date:

$2000 \times \frac{6}{100} \times \frac{1}{12}$

ACCOMMODATION BILLS:

Generally a bill of exchange is drawn by a creditor on his debtor to settle a trade debt. A Creditor is a person who has sold goods on credit basis and a debtor is a person who has purchased goods on credit basis. Thus, a bill which is drawn by a creditor and accepted by a debtor is known as a trade bill of exchange.

On the other hand, a bill of exchange which is drawn to oblige a friend or to give him a temporary assistance or to provide him a loan or to accommodate one or more parties, is called 'an accommodation bill'.

Such a bill is drawn and accepted without any sale and purchase of goods. As the bill is drawn to fulfill the temporary need of money so there is no question of retaining this bill by the drawer until the due date. The bill will be discounted and cash will be received immediately. The drawer before maturity date is required to provide the acceptor with funds so that he may meet his acceptance on the due date.

It can be explained with the help of an example. Let us suppose A is in need of money, he approaches his friend B and asks him to give him a loan of Rs. 5,000. B also shows his inability but agrees that he will accept a bill of exchange. A draws a bill on B which he accepts at 3 months. A discounts the bill with his bank and gets the money. After three months but before the due date, A sends Rs. 5,000 to B in order to meet his acceptance. B receives the amount and pays his acceptance.

Following is the distinction between the trade and the accommodation bills.

Trade Bills	Accommodation Bills
1. These bills are drawn by creditors and accepted by debtors.	1. These are not drawn by creditors.
2. These are drawn against proper consideration.	2. These are drawn without any consideration.
3. Trade bill is a proof of debts.	3. An accommodation bill is not a proof of debts.

NOTE:

The accounting treatment for accommodation bills is almost similar to that of trade bills.

An Accommodation bill can be drawn in three different ways:-

(1) **When it is drawn for the accommodation of drawer only. (only one party is benefited):**

ILLUSTRATION NO. 14 SL

X approached his friend Y for a loan of Rs. 5,000. Y being unable to give him the money, agreed to accept a bill drawn on him at 3 months. X drew and Y accepted the bill. X discounted the bill with his bank at 12% p.a. On the due date X remitted the amount to Y in order to meet his acceptance. Y met his acceptance.

Pass the entries in books of both the parties.

Solution:

X'S JOURNAL

	Bill Receivable account.............................Dr. Y account... Acceptance received for 3 months	5000	5000
	Bank account ....Dr. Discount account...................................Dr. Bill Receivable account.......................... Bill discounted to raise funds	4850 150	5000
Due Date:	Y account..Dr. Cash account.................................... Cash sent to Y so that he could meet his acceptance.	5000	5000

$5000 \times \frac{12}{100} \times \frac{3}{12}$

NOTE: We passed no entry for credit sales.

Y'S JOURNAL

	X account..Dr. Bill Payable account........................... Acceptance given 3 months	5000	5000
	Cash account..Dr. X account.. Amount received from X to honour the bill on maturity	5000	5000
	Bills Payable account...............................Dr. Cash account.................................... Payment made to the bank on the due date.	5000	5000

NOTE: We passed no entry for credit purchase because this is a case of an accommodation bill in which no trade takes place.

(2) When an accommodation bill is drawn for the benefit of both the parties:

In this case one person draws a bill on other person and after receiving acceptance, discounts it and the proceeds (the amount received from bank) are shared equally or according to mutual agreement. On maturity, the remaining amount is sent by the drawer to the acceptor to meet the bill. The discount is also borne by the two parties in the same ratio in which they shared the proceeds of the bill. Such a bill which is drawn for the benefit of both the parties, is known as 'mutual accommodation bill'. For example A and B are in need of finance. A draws a bill on B for Rs. 10,000 at two months for the mutual benefit of both of them. B accepts the bill and returns it to A. A discounts the bill with his banker at 12% p.a. He gets Rs. 9,800 from the bank (Rs. 200 discount charged by bank). On the same date, A remits half of the proceeds (Rs. 4,900) to B. In this way both the parties are benefited by getting equal amount of money. Discount is also borne equally by the two parties. On the due date, A will remit the remaining amount to B (the acceptor) to meet the bill.

ILLUSTRATION NO. 15

On 1st July, 1991, Aslam drew a bill for Rs. 5,000 on Akram at 3 months for mutual accommodation. Aslam discounted the bill at 12% and remitted half of the proceeds to Akram. On the due date he sent the remaining amount to Akram to meet the bill. Akram met this acceptance. Give entries in the books of Aslam and Akram.

Solution:

ASLAM'S JOURNAL

1.7.91	Bill Receivable account..........................Dr. Akram account.................................... Acceptance received at 3 months.	5000	5000
1.7.91	Bank account..Dr. Discount account.......................................Dr. Bill Receivable account....................... Bill discounted at 12% p.a. and amount received from bank.	4850 150	5000
2.7.91	Akram account....................................Dr. Bank account.................................... Discount account............................... Half the proceeds of the bill sent to Akram and half the discount charged to him.	2500	2425 75
4.10.91	Akram account.....................................Dr. Bank /Cash account........................... Remaining amount sent to Akram to meet the bill.	2500	2500

Amount sent by a cheque.

AKRAM'S JOURNAL

1.7.91	Aslam account.....................................Dr. Bill payable account........................... Acceptance given to Aslam for mutual accommodation.	5000	5000
2.7.91	Bank account..Dr. Discount account..................................Dr. Aslam account................................ Half the amount received from Aslam and discount borne.	2425 75	2500
4.10.91	Bank / Cash account..............................Dr. Aslam account .... On maturity, remaining amount received from Aslam.	2500	2500
4.10.91	Bill payable account...............................Dr. Bank/Cash account.......................... Acceptance met and full amount of the bill paid to bank on maturity.	5000	5000

(3) Mutual accommodation, when bills are drawn on each other:

Under this case, for the mutual benefit of both the parties, each draws a bill on other for the same amount and term, so on maturity none is to remit any amount and each is to meet his own acceptance. For example, A and B are in need of money. A draws a bill on B for Rs. 5,000 at three months which is accepted by B. On the same date B also draws a bill on A for the same amount and period. Both parties discount their bills and get the money. On maturity, they will meet their own acceptances. In this way both the parties are benefited.

ILLUSTRATION NO. 16 SL

On 1st Jan., 1991, X and Y draw bills on one another at 3 months for Rs. 2,500 for their mutual accommodation. They discount each other's bills at 12% p.a. at their respective banks. At maturity each party honours its own acceptance. Pass the entries in the books of both the parties.

Solution:

X's Journal			Y's Journal		
1.1.91			1.1.91		
Bill Receivable A/c	2500		X A/c	2500	
Y A/c		2500	Bill payable A/c		2500
Acceptance received at 3 months			Acceptance given at 3 months		
1.1.91			1.1.91		
Y A/c	2500		Bill Receivable A/c	2500	
Bill payable A/c		2500	X A/c		2500
Acceptance given at 3 months			Acceptance received at 3 months		
1.1.91			1.1.91		
Bank A/c	2425		Bank A/c	2425	
Discount A/c	75		Discount A/c		75
Bill Receivable A/c		2500	Bill Receivable A/c		2500
Bill discounted at 12% p.a. and amount received from bank.			Bill discounted at 12% p.a. and amount received from the bank.		
4.4.91			4.4.91		
Bill payable A/c	2500		Bill Payable A/c	2500	
Cash / Bank A/c		2500	Cash / Bank A/c		2500
On maturity acceptance met and amount is paid to Y's bank			On maturity acceptance met and amount paid to X's bank.		

EFFECT OF INSOLVENCY:

In the accommodation bills when any person becomes insolvent, he is considered to be unable to pay his liabilities. It means that the bills accepted by him will be naturally dishonoured. Thus when it is known that a person has become insolvent, entry for dishonour of his acceptance should be passed both in the books of the acceptor as well as in books of the drawer. Then ledger account of the insolvent person should be prepared in the books of the drawer. His account will show the amount due from him. If any amount is received from his private estate, cash account will be debited and his personal account will be credited in the books of the drawer. The remaining amount being irrecoverable should be written off as bad debts.

ILLUSTRATION NO. 17 SL

Arshad and Ashraf were in need of funds. Therefore, on 1st June, 1991, Arshad accepted a bill for Rs. 5,000 drawn on him by Ashraf at three months. Ashraf got the bill discounted at 12% p.a. by his bank and remitted half of the proceeds to Arshad. On the due date, however, Ashraf was not in a position to remit the remaining half of the amount to Arshad, rather he agreed to accept a bill for Rs. 3,000 drawn by Arshad for three months, which Arshad discounted for Rs. 2,900 at his bank and met his acceptance. Before the second bill was due for payment, Ashraf became insolvent and a dividend of 50 paisa in a rupee was only received from his estate. Pass the journal entries in the books of both the parties and give Ashraf's account in the books of Arshad.

Solution:

	Ashraf's Journal	Arshad's Journal
	1.6.91 Bill Receivable A/c 5000 Arshad A/c 5000 Acceptance received at 3 months	1.6.91 Ashraf A/c 5000 Bill Payable A/c 5000 Acceptance given at 3 months
	Bank A/c 4850 Discount A/c 150 Bill Receivable A/c 5000 Bill discounted at 12% p.a.	No entry.
Discount is Shared equally.	Arshad A/c 2500 Bank A/c 2425 Discount A/c 75 Half the proceeds sent to Arshad	Bank A/c 2425 Discount A/c 75 Ashraf A/c 2500 Proceeds received and discount borne.
	4.9.91 Arshad A/c 3000 Bill Payable A/c 3000 Acceptance given at 3 months in order to provide funds to Arshad	4.9.91 Bill Receivable A/c 3,000 Ashraf A/c 3,000 Acceptance received at 3 months in order to meet the first bill
	No entry	Bank 2900 Discount A/c 100 Bank Receivable A/c 3000 Bill discounted for Rs. 2900

No entry	Bill Payable A/c 5000 Bank A/c 5000 Acceptance met and amount paid to the bank.
7.12.91 Bill Payable A/c 3000 Arshad A/c 3000 Bill dishonoured due to insolvency.	7.12.91 Ashraf A/c 3000 Bank A/c 3000 Bill dishonoured due to acceptor's insolvency and amount paid to the bank.
Arshad A/c 2500 Cash A/c 1250 Deficiency A/c 1250 Cash paid to Arshad on insolvency	Cash A/c 1250 Bad debts A/c 1250 Ashraf A/c 2500 Cash received and balance written off as bad debts.

At this stage Ashraf's account should be prepared.

Ashraf's account (In books of Arshad)

Amount due from Ashraf is Rs. 2500 when he became insolvent.

1.6.91	Bill Payable A/c		5000	1.6.91	Bank A/c		2425
7.12.91	Bank		3000	1.6.91	Discount A/c		25
				4.9.91	Bill Receivable A/c		3000
				4.9.91	Cash A/c		1250
				4.9.91	Bad debts		1250
			8000				8000

NOTE: When a person becomes insolvent, his account is closed by treating the amount due from him as bad debts.

ILLUSTRATION NO. 18 52

Tariq drew and Mahmood accepted a bill for Rs. 10,000 on 1st Jan. 1991 for their mutual accommodation payable after two months. Tariq discounted the bill from his bank at 12% p.a. and remitted half of the proceeds to Mahmood.

On 1st Feb. 1991, Mahmood drew and Tariq accepted a bill for Rs. 5,000 at two months. Mahmood discounted the bill with his banker at 12% p.a. and sent half of the amount to Tariq. On 4th March, Mahmood honoured his acceptance but on 4th April, Tariq failed to meet his acceptance and so Mahmood had to take it up. Mahmood then drew another bill on Tariq for the balance due from him plus interest of Rs. 300 which was accepted by Tariq at two months. Before the due date of his bill, Tariq became insolvent and on 30th June, 25 paisa in the rupee was received as a first and final dividend from his estate. Give entries in the books of Mahmood and Tariq's account in the books of Mahmood.

Solution:

MAHMOOD'S JOURNAL

Margin note	Date	Particulars	L.F.	Dr.	Cr.
	1.1.91	Tariq account....Dr. Bill Payable account .... Acceptance given at two months.		10,000	10,000
Discount is also shared equally: $\frac{200}{2}$	1.1.91	Cash account/Bank A/c....Dr. Discount account....Dr. Tariq account.... Half of the proceeds received from Tariq as the bill accepted was for mutual accommodation.		4900 100	5000
	1.2.91	Bill Receivable account....Dr. Tariq account.... Acceptance received at two months		5000	5000
	1.2.91	Bank account....Dr. Discount account....Dr. Bill Receivable account.... Bill discounted at 12% p.a.		4900 100	5000
$4900 \div 2 = 2450$ $100 \div 2 = 50$	1.2.91	Tariq account....Dr. Bank/Cash account.... Discount account.... Half of the amount received from bank is sent to Tariq.		2500	2450 50
Mahmood honoured his bill.	4.3.91	Bill Payable account....Dr. Cash account.... Acceptance met on maturity and amount paid to bank.		10,000	10,000
To know the amount due from Tariq, we should prepare Tariq's account at this stage.	4.4.91	Tariq account....Dr. Bank account.... Bill dishonoured by Tariq and so amount paid to Bank.		5000	5000
	"	Tariq account....Dr. Interest account.... Interest due from Tariq.		300	300
Amount due (we) found out from Tariq's account	4.4.91	Bill Receivable account....Dr. Tariq account.... New acceptance received for the amount due from Tariq.		7800	7800

		Tariq account.....................................Dr.		7800	
		Bill Receivable account...............			7800
		Bill dishonoured due to acceptor's insolvency.			
Amount due was Rs. 7800	30.6.91	Cash account.....................................Dr.		1950	
$7800 \times \frac{25}{100} = 1950$		Bad debts account..............................Dr.		5850	
Cash received = 1950		Tariq account..............................			7800
Bad debts = 5850		Cash received from private estate of Tariq as 25 paisa in a rupee and remaining amount was written off as bad debts.			

TARIQ'S ACCOUNT

1.1.19	Bill Payable A/C	10,000	1.1.91	Cash A/C	4900
1.2.91	Bank A/C	2450	1.1.91	Discount A/C	100
1.2.91	Discount A/C	50	1.1.91	Bill Receivable A/C	5000
4.4.91	Bank A/C	5000	4.4.91	Bill Receivable A/C	7800
4.4.91	Interest A/C	300	30.6.91	Cash A/C	1950
	Bill Receivable A/C	7800	30.6.91	Bad debts A/C	5850
		25600			25600

BILLS RECEIVABLE AND BILLS PAYABLE BOOKS:

As we have already discussed mainly the journal entries for transactions in bills of exchange. Recording the transactions in general journal is very convenient, if the transactions are a few. But where numerous bills are drawn and accepted by a businessman, then it is advisable for him to record them in special journals (books) known as '**Bills Receivable Book and Bills Payable Book**. The bills drawn and received are recorded in Bills Receivable Book and bills accepted in Bills Payable Book.

The total of the Bills Receivable Book shows the total amount of the bills drawn and received. This total will be posted to the debit side of Bill Receivable Account in ledger. The parties from whom the bills have been received will be credited with the amount shown against their names. In the same way, the total of the Bill's Payable Book will be posted to the credit side of Bills Payable Account in ledger. The parties to whom the acceptances have been given are debited.

When these two special books are maintained in a business, the general journal is used only for the following bills transactions.

(1) When a bill is endorsed in favour of a creditor.

(2) When a bill receivable and a bill payable are dishonoured.

(3) When a bill is renewed.

The format of Bills Receivable and Bills Payable Book is shown below:

Figure No. 7

Bills Receivable Book

Serial No.	Date	From when received	L/R	Name of acceptors	Date of Bill	Term	Due date	Where Payable	Amount	How disposed off	Remarks

Figure No. 8

Bills Payable Book

Serial No.	Date	Name of Drawer	L/R	Name of Payee	Term	Due date	Where Payable	Amount	Remarks

NOTE:

The details of these books will be given in a separate chapter **'Special Journals'.**

PROMISSORY NOTE:

A promissory Note has been defined in the Negotiable Instrument Act, 1881 as **"A promissory Note is an instrument in writing (not being a bank note or a currency note) containing an unconditional undertaking signed by the maker to pay a certain sum of money only to or to the order of a certain person or to the bearer of the instrument."**

This definition means that when a person gives a promise in writing to pay a certain sum of money unconditionally to another person or according to creditor's instructions, this document is called a promissory note. It is generally used for loan purposes.

SPECIMEN OF PROMISSORY NOTE

Rs. 10,000	Lahore
Stamp	1st Jan. 1991

Three months after date, I promise to pay Mr. X or order the sum of Rs. Ten Thousand only for value received.

Mr. Y

The accounting treatment for Promissory Notes is almost the same as that of Bills of Exchange.

CHARACTERISTICS OF A PROMISSORY NOTE:

1. It should be in writing.
2. It is a promise by a debtor to pay.
3. The promise is always for payment of money.
4. It is always unconditional.
5. Acceptance is not essential.
6. It can be endorsed.

TEST YOUR KNOWLEDGE

1. Fill in the blanks:

(a) When the bill is met on the due date..........account is debited in books of the drawee.

(b) When the bill discounted with the bank is dishonoured.........account is debited and ....account is credited in the books of the drawer.

(c) When the bill is dishonoured..........account is debited in the books of the drawee.

(d) When the bill is dishonoured........account is debited in the books of the drawer.

(e) When an endorsed bill is dishonoured........ account is credited in the books of the drawer.

(f) The drawer always debits ...... account for noting charges paid on dishonour of a bill.

(g) When a bill is renewed, interest account is ....in the books of the drawer.

(h) When a party becomes insolvent, the bill accepted by him is treated as ....

Ans: [(a) Bill Payable (b) Acceptor's, Bank (c) Bill Payable (d) Acceptor's (e) Endorsee's or creditor's (f) Acceptor's (g) Credited (h) Dishonoured].

2. State whether the following statements are correct or incorrect:

(a) The drawer debits drawee's account and credits noting charges account for noting charges paid by the endorsee of the bill.

(b) No entry is passed in books of the acceptor when a bill is discounted with the bank.

(c) A bill discounted with the bank or sent to the bank for collection is treated in the same way in the books of the drawer.

(d) Interest on renewal of a bill is a revenue to the drawer and an expense to the drawee.

(e) Noting charges paid on dishonour of a bill is an expense to the drawee.

Ans: [(a) Incorrect (b) Correct (c) Incorrect (d) Correct (e) Correct].

QUESTIONS

1. Define and explain a Bill of Exchange. What are its uses?
2. What is meant by discounting of a bill? Why is it made? Give entries for discounting of a bill.
3. What do you mean by endorsement of a bill?
4. What is an accommodation bill and how does it differ from a trade bill?
5. What is dishonour of a bill? How does it affect the books of accounts?

PROBLEMS

1. A sells goods to B for Rs. 10,000 and draws a bill for 3 months. B accepts the bill and returns it to A. The bill is honoured on the due date. Give journal entries in the books of A and B under the following circumstances.
   (a) When the bill is kept by A with himself till due date.
   (b) When the bill is endorsed to C, his creditor.
   (c) When the bill is sent to the bank for collection.
   (d) When the bill is discounted with the bank at 12% per annum.

2. X sells goods to Y for Rs. 5,000, and draws a bill for 3 months. Y accepts the bill and returns it to X. On maturity, the bill is dishonoured by Y. Pass the journal entries in the books of the drawer under the following circumstances:
   (a) If the bill is retained by X with himself till due date.
   (b) If the bill is endorsed to Z, his creditor.
   (c) If the bill is sent to the bank for collection.
   (d) If the bill is discounted immediately at 12% p.a.

3. On 1st January, 1991 X sells goods to Y for Rs. 10,000 and draws three bills on him: the first bill for Rs. 3,000 for one month, the second for Rs. 5,000 for two months and the third for Rs.2,000 for 3 months. Y accepts and returns these bills to X.

   The first bill is retained by X till the date of maturity. The second bill is discounted by him on 4th Jan. at 12% p.a. with his banker. The third bill is endorsed by X to his creditor A on 5th Jan. 1991.

   On maturity all the bills are honoured by Y. Give entries in the books of X, Y and A.

4. On 1st July 1991, Aslam sells goods to Akram for Rs. 50,000 and draws four bills on him: the first for Rs. 10,000 at one month, the second for Rs. 15,000 for two months, the third for Rs. 20,000 for three months and the fourth for Rs. 5,000 at 4 months.

   Akram accepts the bills and returns them to Aslam. The first bill is endorsed by Aslam to his creditor Sarwar on 3rd July. The second bill is discounted by him at 12%, p.a. on 4th July. The third bill is sent to the bank for collection on 5th July. The fourth bill is retained by him till the due date.

   On maturity all the bills are duly presented to Akram but returned dishonoured with the exception of fourth bill. Pass the entries in the books of Aslam and Sarwar.

5. Imran sells goods to Farhan for Rs. 8,000 and draws a bill for 4 months on him. Farhan accepts the bill and returns it to Imran. After three months Farhan gets the bill retired under a rebate of 12% p.a. Journalise the transactions in the books of both the parties.

6. On 1st January, 1991 Shahid sold goods to Zahid for Rs. 5,000 and drew a bill for 4 months on him. Zahid accepted the bill and returned it to Shahid. Shahid got it discounted by his bank at 15% p.a.

   On maturity Zahid was not in a position to meet his acceptance. He approached Shahid and requested him to cancel the old bill and draw on him a new bill for the amount of old bill plus interest at the rate of 12% p.a. at 3 months. Shahid agreed to the proposal. On the due date of the new bill, Zahid honoured his acceptance. Give journal entries in books of Shahid and Zahid.

A is debtor of B

7. A owes B a sum of Rs. 1,500. On 1st January, 1991, he accepts a bill for the amount for 3 months drawn on him by B. B gets it discounted with his banker for Rs. 1,450. On the due date the bill is dishonoured, the bank pays Rs. 20 as noting charges. Then A pays Rs. 400 in cash and accepts another bill drawn on him by B for the balance together with interest of Rs. 30. This bill of exchange is for two months and on the due date the bill is honoured by the acceptor A. Pass the journal entries in the books of B and A.

8. A sold goods to B for Rs. 15,000 and drew on B a bill for the amount at 3 months. A endorsed the bill to his creditor C. C endorsed it to his creditor D. D got the bill discounted by his bank at 12% p.a. On maturity the bill is dishonoured and bank pays Rs. 30 for noting charges.

   Req. Pass entries in the books of A, B, C, D and the bank.

9. On 1st January, 1991, X sells goods to Y for Rs. 10,000. X draws three bills on Y; the first for Rs. 3,000 for one month, the second for Rs. 5,000 for two months and the third for Rs. 2,000 for 3 months.

   The first bill is endorsed by X to his creditor Z on 3rd January. The second bill is discounted at bank on 4th January for Rs. 4,850. The third bill is retained by X until due date. The first bill is met at maturity. The second bill is dishonoured and the bank pays Rs. 20 for noting charges. On Y's request, X draws a fourth bill on Y for Rs. 5,050 including Rs. 30 as interest. Y accepts the bill at two months. On maturity, the third and the fourth bills are honoured. Show the entries in the books of X, Y and Z.

10. Asim sells goods to Akif for Rs. 10,000 on March 1, 1991. Asim draws a 3 months bill on Akif which he accepts. Asim gets it discounted by his banker at 10% p.a. On the due date the bill is dishonoured, the bank pays Rs. 30 as noting charges. However, Akif pays Rs. 4,060 in cash (Rs. 60 for noting charges and interest) and accepts a new bill for Rs. 6,000 for two months. On the due date Akif approaches Asim again and asks for renewal of the bill for a further period of 3 months. Asim agrees to the request provided Akif pays Rs. 30 as interest in cash. The last bill is paid by Akif one month before its maturity under a rebate of Rs. 15.

    Req. Pass the journal entries in the books of Asim and Akif.

11. Journalise the following transactions in the books of Asif:-

    (i) Saleem's acceptance to Asif for Rs. 2,000 which Asif endorsed in favour of Rauf was dishonoured. Rauf paid Rs. 20 as noting charges. Asif paid Rs. 20 to Rauf by a cheque and received a new acceptance from Saleem for the amount due plus interest Rs. 40.

    (ii) Asif renewed his acceptance to Amir for Rs.1,000 by a cheque of Rs. 400 and a new bill at 3 months at 10% p.a. interest.

    (iii) Farid's acceptance to Asif for Rs. 3,000 renewed for two months at 12% p.a. interest.

    (iv) Asif's acceptance to Haseeb for Rs. 5,000 was got retired one month before its maturity under a rebate of 12% p.a.

    (v) Asif's acceptance to Ansar for Rs. 1,000 was discharged by Javed's acceptance to Asif for a similar amount.

    (vi) Asif's acceptance to Farooq for Rs. 5000 was discharged by paying Rs. 2,000 in cash and accepting a new bill for the balance for two months, interest at 12% p.a. being paid in cash.

12. On 1st January, 2001 Mr. Asif sold goods to Mr. Azam for Rs. 30,000. Azam paid Rs. 6,000 in cash and accepts three bills for balance. The first bill for Rs. 7,000 at one month, the second for Rs. 8,000 at two months and the third for Rs. 9,000 at three months.

Asif endorsed 1st bill to Irfan his creditor on 2nd January in full settlement of Rs. 7,100; discounted the 2nd bill at his bank for Rs. 7920 and retained the third bill till maturity.

The first bill is met at maturity. The second bill is dishonoured and Rs. 100 being paid as noting charges. Asif charges Rs. 150 for interest and draw on Azam a fourth bill for the amount at three months. At maturity the 3rd bill was renewed with interest of 10% p.a. for three months. The 5th bill was duly accepted by Azam. The fourth and fifth bills were met on maturity.

Req. Give journal entries in the books of Asif.

13. On 1st January, 1991, A bought a golden chain for Rs. 10,000 from B and accepted two bills of exchange in settlement, one for Rs. 6,000 at four months and second for Rs. 4,000 payable after six months. The first bill was honoured on the due date, but before the second bill fell due, it was cancelled by mutual consent and a new bill for three months was accepted by A for the amount of the second bill plus interest Rs. 100. B sent this bill to his bank for collection. But on the due date the bill was dishonoured.

Req. Record the above transactions in the books of B and A.

INSOLVENCY

14. Salman sold goods to Rizwan for Rs. 50,000 on Ist July, 1991 and drew on him a bill for the amount payable after four months. Rizwan accepted the bill. Salman got it discounted by his bank at 12% p.a. On maturity Rizwan was in a position to pay only Rs. 20,000 in cash, therefore, he approached Salman for the renewal of the bill. Salman agreed and drew a new bill for Rs. 30,000 along with an interest at 15% p.a. for 3 months.

Before the due date of the new bill Rizwan became insolvent and a first and final dividend of 50% was received from his estate.

Pass the entries in the books of Salman and Rizwan and also give Rizwan's ledger account.

15. A sold goods to B for Rs. 40,000 on 1st July, 1991 and on the same day drew a bill on B at 3 months for the amount. B accepted the bill and returned it to A, who discounted it on 4th August with his bank at 12% p.a. The bill was dishonoured on the due date (4th October) and the bank paid Rs. 400 as noting charges.

On 10th October 1991, B was declared as insolvent and his estate paid a first and final dividend of 50 paisa in the rupee on 31st December, 1991.

Pass journal entries in the books of A and show how B's account will appear in A's ledger.

16. On 1st September 1991 A's account in the books of B shows a debit balance of Rs. 2,000. On the same day B drew a bill on A at 2 months for Rs. 2,000. The bill was dishonoured on the due date. B's accounts are made up to 31st December each year.

B then filed a suit against A for the amount due and the judgment is obtained on Ist March, 1992, for the amount of debt with interest at 6% p.a. from Ist January 1992 up to the date of payment together with legal costs amounting to Rs. 195. A paid the decreed amount on 16 March 1992.

Give journal entries and A's account in the books of B.

ACCOMMODATION BILLS:

17. Waseem and Kalim are in need of funds. For their mutual accommodation Waseem draws a bill on Kalim for Rs. 6,000 at two months which Kalim accepts. Waseem gets the bill discounted by his bank at 12% p.a and sends half of the proceeds to Kalim. Before the due date Waseem sends the remaining amount due to Kalim and Kalim pays the bill on the due date. Pass journal entries in the books of Waseem and Kalim.

18. For mutual accommodation, A draws a bill on B for Rs. 5,000 at two months which is accepted by B. On the same date B draws a bill on A for a similar amount at two months Both the parties get their bills discounted by their respective banks at 12% p.a. On the due date both the bills are honoured. Give journal entries in books of A and B.

19. On 1st October, 1991, A drew a bill for Rs. 18,000 on B payable after two months for their mutual accommodation to the extent of 3/4 and 1/4 respectively. The bill was duly accepted and returned by B. A got it discounted by his bank at 10% p.a. and remitted 1/4 of the proceeds to B. Before the due date A sent him the balance but B dishonoured the bill on the due date and A had to pay his banker the amount of the bill along with noting charges Rs. 60.

A then drew and B accepted a fresh bill for the amount due plus interest Rs. 300 for two months. On maturity B paid only Rs. 5,000 to A and requested A to draw on him another bill for the amount due plus interest Rs. 200. A agreed to the proposal.

But before the due date of this bill, B became insolvent and a dividend of 25 paisa in a rupee was received from his estate.

Pass the journal entries in the books of A and B and show how B's account will appear in A's ledger.

20. On 1st January, 2001 A drew and B accepted a bill at three months for Rs. 10,000. On 4th January A discounted the bill at his bank for 12% p.a. and remitted half the proceeds to B. On 1st February, 2001 B drew and A accepted a bill at three months for Rs. 2,500. On 4th February B discounted the bill with his bank at 12% p.a. and remitted half the proceeds to A. A and B agreed to share the discount equally.

At maturity A met his acceptance but B failed to meet his and A therefore had to pay it. A then drew and B accepted a new bill of three months for the amount of the original bill plus Rs. 150 for interest. On 1st July 2001, B became insolvent and paid to his creditors 60 paisa in a rupee in full satisfaction.

Write up journal entries and B's account in A's books.

21. A for mutual and temporary financial help of himself and of B draws upon the latter a bill of exchange at 3 months for Rs. 12,000 dated 1st January, 1991. B accepts the bill and returns it to A. A discounts the bill immediately at his bank, the rate of discount being 12% p.a. and hands over half of the proceeds to B. B for a similar purpose and at the same time, draws a bill at 3 months on A for Rs. 5,000. A accepts the bill. B gets the bill discounted at 12% p.a. and hands over half of the proceeds to A. On 31st March, 1991, B becomes insolvent and so fails to meet his acceptance on maturity. On 30th June, 1991, a first and final dividend of 50 paisa in a rupee was received from B's estate.

Pass the journal entries in the books of A and B and also give B's account in A's books.

22. For their mutual accommodation, Fida accepted a bill on 1st March, 1991, drawn on him by Aqeel for Rs. 6,000 at three months. The bill was got discounted at 10% p.a. and the proceeds were shared equally.

On 1st April, 1991, Fida drew a bill for Rs. 9,000 on Aqeel at three months for the same purpose. Aqeel accepted the bill. Fida got the bill discounted at 10% p.a. and the proceeds were shared as 2/3 to Fida and 1/3 to Aqeel. Before the due date of the first bill. Fida sent a cheque to Aqeel in full settlement of his account. On 15th June 1991, Aqeel became insolvent and his estate paid a dividend of 50 paisa in a rupee.

Give journal entries and Aqeel's account in the books of Fida.

23. For their mutual accommodation A draws a bill for Rs. 5,000 on B for three months. B accepts it and returns it to A. The proceeds of the bill are to be shared by A and B in the ratio of 3/5 and 2/5 respectively. The bill is discounted by A for Rs. 4,975 and he remits 2/5 of the proceeds to B. Before the due date B draws another bill for Rs. 10,000 on A at three months with the help of these proceeds the first bill is met by B and the remaining proceeds are shared by A and B in the ratio of 2/5 and 3/5 respectively. The bill is discounted for Rs. 9,950. Before the due date of the second bill A becomes insolvent and his estate pays only 25% of the debts.

Pass the entries in the books of both the parties.

(P.U. B. Com. I 1990)

24. Faisal draws on Umair a bill of exchange for Rs. 2,500 on 1st January 1991 at three months for mutual accommodation. Umair accepts the bill and sends it to Faisal who gets it discounted for Rs. 2,400 and remits immediately half of the proceeds to Umair. On 31st March, 1991, Faisal, unable to send the remaining amount to Umair, accepts a bill for Rs. 1,800 for three months which is discounted by Umair for Rs. 1,750. Umair sends Rs. 450 to Faisal.

Before the maturity of the bill accepted by Faisal, he becomes insolvent and his creditors get forty paisa in the rupee.

Give the journal entries in books of both the parties. Also show Faisal's account in Umair's books.

25. Amir for mutual accommodation draws a bill for Rs. 15000 on Yasir at three months. Amir gets the bill discounted by his banker for Rs. 14625 and remits Rs. 4875 to Yasir. On maturity Amir is not able to send the amount due to Yasir, to enable him to meet the bill. He, however, accepts a bill for Rs. 18750 which is discounted by Yasir for Rs. 17625. Yasir meets his acceptance and remits Rs. 900 to Amir. Before the due date of the bill Amir becomes insolvent and a dividend of 60 paisa in the rupee is received from his estate.

Req. Pass journal entries and show account of Amir in the books of Yasir.

CHAPTER - 7

SPECIAL JOURNALS

SPECIAL JOURNALS

Under double entry system transactions are first of all recorded in journal and thereafter posted to the ledger. We already know that the 'Ledger' is the main book of account. The book which gives additional help to the main book (Ledger) is called subsidiary book. Thus the journal is a subsidiary book and the ledger is a main book. The 'Journal' is an old French word meaning 'Daily Record', and it is called so because everything that happened everyday is recorded into the book at once, before the exact details of transaction are forgotten. It is in the journal that the 'original documents' (Invoices etc.) are recorded.

In small business concerns only one journal and one ledger may serve the purpose, because the number of transactions is very small. But in large business concerns the number of transactions are numerous, just one journal and one ledger will not do the job. That will cause much inconvenience i.e., if we have only one journal in a large scale business, it is not possible only for one book-keeper to record all the transactions in time. On the other hand, it will not be possible for more than one person to use the same journal simultaneously with the result that the accounting work will fall in arrear.

Subdivisions also called special journals

Thus in a large business concern a journal is divided into parts so that several clerks could work at the same time. This is known as 'Subdivision of Journal'.

There are, however, some more factors which necessitate the use of more than one subsidiary book (Journal):

(1) If all the transactions are recorded in one book (Journal), the book will be very large, bulky and difficult to handle.

(2) If one book-keeper is asked to record all the transactions, the possibility of errors and mistakes will be great. It will also create opportunities for committing fraud.

(3) If all the transactions are recorded in one book, it will be difficult to trace out a particular transaction in future.

ADVANTAGES:

The following advantages are derived from division of journal:

(1) Because of subdivision the books cannot be bulky and hence there will be no difficulty in handling them.,

(2) Accounting work is divided amongst a large number of employees. So work is done nicely and promptly and no work is left in arrear.

(3) Each employee can be held responsible for mistakes committed by him. This serves as caution and care to the employees.

(4) The efficiency of the employees increases, because of the division of labour.

(5) By keeping the book under the custody of different employees the chances of fraud and defalcation are minimized.

SUBDIVISION OF JOURNAL:

From the above discussion it is clear that for a large business concern, one journal is not sufficient to record all business transactions and there should be several journals (subsidiary books or special journals) and several clerks to record the transactions. But how many journals a business should have?

We know that different types of transactions take place in a business concern. Some transactions take place repeatedly (hundreds to thousands times in a year) and some transactions take place once or twice in a year. Obviously, it is not logical to provide a separate journal for transactions which rarely take place.

For this purpose different groups of transactions are made and a separate book is provided for each group. Each group is consisted of similar types of transactions:

Journal is mainly divided into two:

(1) Special Journal (2) General Journal

The subdivisions are discussed in details below:

(1) SPECIAL JOURNAL:

By special journal we mean a journal in which transactions relating to a certain special group are recorded. Special journal is again subdivided into eight groups:

(i) Purchases Book or Purchases Journal:

Whenever goods are purchased by a business on credit, these are recorded in this book. (Cash is not involved). So this is a 'special journal' only and only for credit purchases. Other names of this book are Purchase Day Book, Bought Book, Bought Journal, Inward Invoice Book or only Invoice Book.

(ii) Sales Book or Sales Journal:

Whenever goods are sold to the customers on credit (without receiving cash immediately), these are recorded in this book. So this is a 'special journal' only for credit sales. Other names of this book are Sales Day Book, Outward Invoice Book or only Day Book.

(iii) Purchases Returns Book or Purchases Returns Journal:

The goods we have bought on credit if subsequently returned by us to the suppliers for some solid reasons, are recorded in this book. Here the goods go out of our possession; so the book is also called 'Returns Outward Book.'

(iv) Sales Returns Book or Sales Returns Journal:

The goods we have sold on credit subsequently returned by the customers for some solid reasons are recorded in this book. This book is also known as 'Returns Inward Book'.

(v) Bills Receivable Book:

Sometimes debtors pay by means of accepting a bill of exchange instead of cash. All the bills (acceptances) received from the debtors are recorded in this book.

(vi) Bills Payable Book:

Sometimes creditors are paid by means of accepting the bills drawn by them instead of paying them cash. All the bills (acceptances) given to the creditors are recorded in this book

(vii) Cash Book Or Cash Journal:

All the transactions in which cash is involved, (whether the business has paid cash or received cash) are recorded in this book.

(viii) Petty Cash Book:

Apart from cash book, for small or petty expenses, another book is maintained which is known as 'Petty Cash Book'. The expenses such as, traveling, coolie, postage etc. are recorded in this book It is a part of the cash book.

(2) GENERAL JOURNAL:

The transactions which do not fall within the scope of above mentioned books, are recorded in this journal , e.g. purchase of an asset on credit, depreciation on assets, expenses payable, bad debts etc It is also known as Journal Proper, Modern Journal or Principal Journal. Some authors call it only 'Journal'.

NOTE:

The main function of the above books is to supply necessary information to the Ledger. All the transactions are posted in the Ledger on the basis of information available from these books, so these books are called 'Subsidiary Books' of Ledger.

The subdivisions of Journal are given below in a tabular form:

Journal

- Special
  1. Purchase Journal
  2. Sales Journal
  3. Purchase Returns Journal
  4. Sales Returns Journal
  5. Bills Receivable Journal
  6. Bills Payable Journal
  7. Cash Journal
  8. Petty Cash Journal
- General

How the transactions are entered in Special Journals and posted to the Ledger?

The procedure for recording the business transactions in subsidiary books and posting to the ledger will be discussed latter on in this chapter. Firstly some important documents and terms are discussed which are very helpful to understand the procedure of recording and posting.

Documents for sales and purchases--the invoice:

Every business transaction begins with an original document. Purchases and sales begin with the documents known as "**Invoices**" and purchases returns and sales returns are acknowledged by a **"Credit Note"**. In every case it is the seller who makes out the document, sending one copy to the other party in the transaction.

An 'invoice' is a business document which is made out whenever one person sells goods to another. It can be used as in the courts of law an evidence of a contract for the sale of goods. It is made out by the person selling the goods and in large businesses it may have as many as four copies of different colours.

The first copy is sent by post or by hand to the person buying the goods and he uses it to enter purchases in his 'Purchase Book'. He then keeps the invoice as his copy of the contract of sale. The invoice sent by the seller is an "Outward Invoice" to the seller and the same invoice is "Inward Invoice" to the buyer.

The second copy is kept by the seller with himself and is entered in his Sales Book, and then filed to be kept as his copy of the contract of sale.

The third and fourth copies are sent together to the store department of the seller. The third copy is often called the **'Delivery Note'** and the fourth copy is called the **'Advice Note'.**

An invoice must have the following information:

(1) Names and addresses of both the parties to the contract of sale.

(2) The date of sale.

(3) An exact description of the goods, with quantity and unit price and details of trade discount (if any) given.

(4) The terms on which goods are sold i.e. discount and credit period. The words 'terms net' means no discount is allowed. The words 'prompt settlement' means no credit period is given.

(5) The letters 'E & O E' are written on the bottom of the invoice. These letters means 'Errors and Omissions Excepted.' If an error or omission has been made, the firm selling the goods may put it right.

SPECIMEN OF AN INVOICE

City Trading Co., Multan. Bought of Punjab Stores The Mall Lahore. Terms: 2% 15 days	No. 7540 Dated: 5th July, 1991
200 kg. of tea @ Rs. 15 per kg. E & O. E	3000
For Punjab Stores Net	3000
Name & Signature	

Figure. 1

NOTE:

The terms 2% 15 days means if the buyer pays the price of goods within 15 days, he will be allowed a cash discount of 2%.

DEBIT NOTE:

If goods bought on credit are returned to the seller for any solid reason, the buyer debits the seller account and informs the seller through a note. This note is called 'Debit Note'.

CREDIT NOTE:

If goods sold on credit are returned by the buyer, the seller credits the buyer account and informs the buyer through a note. This note is called 'Credit Note'.

In a word, Debit Note or Credit Note is nothing but an intimation of having debited/credited the buyer/seller account. Details of goods returned, reasons for return etc. are written on the note.

PURCHASES JOURNAL:

When a businessman places an order for goods that he needs, the seller of the goods (supplier) makes out an invoice. The top copy (first copy) of this invoice is received by the purchaser and is recorded

in the Purchases Journal. There may be several of these invoices arriving every-day, possibly as many as hundred. They will all be the top copies of other selling firm's invoices and the Purchase Journal will be written on the basis of these invoices.

The ruling of every page of the Purchase Journal is given below:

CITY TRADING CO.,

Purchase Journal

Date	Descriptions	Invoice No.	L/F	Details Rs.	Amount Rs.
5.7.1991	**Punjab Stores**				
	200 kg of tea @ Rs. 15/kg	7540	CL[1]	3000	
	Less Trade Discount			NIL	3000
					3000

Figure. 2

EXPLANATION OF FIGURE 2:

In fact there will be many invoices each day, filling several pages of the book by the end of the year. The one invoice shown and recorded is supposed to represent hundreds of invoices recorded within a year. The following points should be noted:

(a) The name of the supplier (Punjab Stores) is written or typed, next to the date. It is underlined.
(b) The details of the transaction are recorded in the next line down, giving a separate line to each item of goods supplied.
(c) Each invoice has a serial number which is written in the column, 'Invoice No.
(d) In the Ledger Folio (L.F) column, the page number of the Ledger where the account of the supplier has been opened, is written.
(e) The 'Details' column shows how net price of goods is determined after deducting trade discount (if allowed) and adding, packing expenses, cartage etc.
(f) The 'Amount' column shows the net price of the goods purchased.

ILLUSTRATION NO. 1 SL

Enter the following transactions in journal (the previous practice) as well as in Purchase Journal and post them to the ledger accounts.

1. **Jan. 10, 1991, purchased 400 kg. of sugar from Saleem & Sons. @ Rs. 10 per kg on credit.**
2. **Jan. 15, 1991, purchased 200 litres of mustard oil from Rehman & Co. @ Rs. 12 per litre.**
3. **Jan. 23, 1991, purchased 100 kg. of Dalda Ghee from Lever Bros. @ Rs. 10 per kg.**

Solution:

According to the previous practice, the transactions are recorded in journal in the following way:

	Rs.	Rs.
Jan. 10, 1991		
Purchases Account .... Dr.	4000	
Saleem & Sons Account		4000
Goods (sugar) purchased on credit		

Jan. 15, 1991

Purchases Account .... Dr. 2400

Rehman & Co. Account 2400

Goods purchased on credit

Jan. 23, 1991

Purchase Account .... Dr. 1000

Lever Bros. Account 1000

Goods (Ghee) bought on credit

But when the Purchase Journal is kept, these transactions are recorded in the Purchase Journal in the following way:

PURCHASE JOURNAL (BOOK) FOLIO (PAGE) 12

In L.F. Column C.L. denotes, creditor's ledger and GL. denotes general ledger.

Date	Description	Invoice No.	L/F	Details Rs.	Amount Rs.
10.1.1991	**Saleem & Sons.** 400 kg. Sugar @ Rs. 10 per kg.	—	CL-8	4000	4000
15.1.1991	**Rehman & Co.** 200 litres mustard oil @ Rs 12 per litre.	—	CL-10	2400	2400
23.1.1991	**Lever Bros.** 100 kg. of Ghee @ Rs. 10 per kg.	—	CL-14	1000	1000
31.1.1991	Purchase account Dr.		GL-16		7400

LEDGER

Saleem & Sons A/C (Folio 8)

	10.1.91 Purchases A/c 4000

Purchase Account (Folio 16.)

31.1.91 Sundry creditors (Total purchase) 7400	

Rehman & Co. A/C (Folio 10)

	15.1.91 Purchases A/c 2400

Lever Bros A/C (Folio 14)

	23.1.91 Purchases A/c 1000

It must be noted that from Purchase Journal, posting is made in four different accounts. Purchase account, Saleem & Sons account, Rehman & Co. account and Lever Bros. account. The Purchase account is debited with the total amount of the three purchases totaling Rs. 7400 (4000 + 2400 + 1000) at the end of the month (31st Jan). Saleem & Sons. account is credited with Rs. 4,000. Rehman & Co. with Rs. 2,400 and Lever Bros. is credited with Rs. 1,000 (becoming creditors of the business).

It is at this point that we can achieve a great saving of labour and time in the posting of these entries into the Ledger. Each of the suppliers who has given us goods, must be credited with the value of goods supplied.

Rule for posting the Purchase Journal.

Credit each supplier's personal account because he has given goods to us.

Debit the Purchases account with the total purchases for the month.

Distinction Between Purchases Journal and Purchases Account.

Purchases Journal	Purchases Account
1. It is a book of original entry--a special journal.	1. It is a book of final entry--a ledger account.
2. Each item of credit purchase of goods is recorded here separately in order of date as soon as the transactions take place.	2. Total of the purchase book (Journal) is recorded at the end of the month.
3. All the details of goods purchased are written here.	3. No details are recorded. only the total amount of purchases during a particular period is recorded.
4. Cash purchases are not recorded.	4. Both cash purchases as wel. as credit purchases are recorded.
5. It is not required for the preparation of final accounts at the end of the year.	5. In final accounts, its balance is shown on the debit side of Trading A/C

SALES JOURNAL (BOOK):

When a business supplies goods to a customer, an invoice of the type described earlier is made out. The top copy is sent to the purchaser who records it in his purchase journal. The delivery of the goods will now take place, but meanwhile the seller who made out the invoice has to record the transaction in his book. The book in which he records the transaction is now the 'Sales Journal'. The second copy of the invoice, which is retained by the seller, will be entered into this book of original entry.

There are so many customers to whom goods are sold in a day. So every day a bundle of invoices made out by the invoice department of the seller, whose top copies have already been sent to the purchasers, will be given to the Sales Journal clerk, who will enter them in the Sales Journal.

The ruling of the Sales Journal is exactly the same as the Purchase Journal, and is illustrated below with the help of an example. Suppose, on 20.1.1991, we sold to Waseem & Sons. 10 cartons of Sunlight Soap @ Rs. 300 per cartoon. We made out an invoice and sent the top copy of invoice to Waseem & Sons. The second copy of the invoice is retained by us. This transaction is recorded in the Sales Journal on the basis of this copy. The sales book will be as follows.

SALES JOURNAL (BOOK)

Date	Descriptions	Invoice No.	L/F	Details Rs.	Amount Rs.
20.1.1991	**Waseem & Sons**				
	10 cartons of Sunlight				
	Soap @ Rs. 300 per carton	262	DL-16	3000	
	Loss Trade discount Nil			NIL	3000
					3000

The different columns of sales book are explained as follows,

1. **Date:** The date of sale of goods is written in this column.
2. **Description:** The name of the person or business to whom goods are sold, details of goods sold etc. are written in this column.
3. **Invoice No:** The serial number of invoice (262) is written in this column.
4. **Ledger Folio:** When goods are sold to a customer, his account is opened in Debtor's Ledger (DL denotes Debtor's Ledger) in the name of the customer. The page number (16) of the ledger where the account has been opened is written in this column.
5. **Details.:** This column shows how the net price of goods is ascertained after deducting trade discount (if allowed).
6. **Amount:** The net price of the goods is written in this column.

ILLUSTRATION NO. 2 SL

Enter the following transactions in the Sales Journal of a trader who deals in furniture and also post them to the ledger accounts.

June 4, 1991, sold on credit to Osman,

10 tables @ Rs. 150.

30 chairs @ Rs. 100.

June 11, 1991 sold on credit to Saleem

1 dining table @ Rs. 1,500

June 30, 1991, sold on credit to Tabaq Restaurant

100 chairs @ Rs. 150

20 tables @ Rs. 200

The trader offers trade discount at the following rates:

Sales up to Rs. 2000 -5%

Sales beyond Rs. 2000-10%

Solution:

SALES JOURNAL (BOOK)

Date	Description	Invoice No.	L/F	Details Rs.	Amount Rs.
4.6.1991	**Osman**	135	DL-15		
	10 Tables @ Rs. 150			1500	
	30 Chairs @ Rs. 100			3000	
				4500	
	Less 10% Trade Discount			450	4050
11.6.1991	**Saleem**				
	1 Dining Table @ Rs. 1500	136	DL-17	1500	
	Less 5% Trade Discount			75	1425
30.6.1991	**Tabaq Restaurant**	137	DL-19		
	100 Chairs @ Rs. 150			15000	
	20 Tables @ Rs. 200			4000	
				19000	
	Less 10% Trade Discount			1900	17100
30.6.1991	Sales A/c Cr.		Gl-30		22575

Saleem A/C (Folio 17)

11.6.91			
Sales	1425		

Tabaq Restaurant A/C (Folio 19)

30.6.91			
Sales	17100		

Osman A/C (Folio 15)

4.6.91			
Sales	4050		

Sales A/C (Folio 30)

		30.6.91	
		Sundry Debtors (Month's Sales)	22575

It must be noted that Sales account has not been credited thrice on three different dates. Instead, it has been credited with the total amount of the three sales aggregating Rs. 22575 (4050 + 1425+ 17100) at a time at the end of the month. The three other accounts (Osman, Saleem and Tabaq Restaurant being debtors) are debited individually.

The students should note that the double entry is perfect. We have debited three accounts separately which totaled Rs. 22,575, the exact amount is credited to Sales account collectively.

PURCHASES RETURNS OR RETURNS OUTWARD JOURNAL

Goods once purchased on credit may subsequently be returned to the seller for certain reasons. The usual reasons for returning goods are:

(a) The purchaser finds that the goods are unsatisfactory for some reasons, e.g. wrong colour, wrong size, not according to the sample, not up to specification, not properly finished; damaged in transit, etc.

(b) The purchaser is entitled by contract to return goods.

We already know that for the buyer, such return of goods to the supplier (seller) are known as purchases returns. While returning goods the buyer sends a 'Debit Note' (discussed earlier) to the seller. The Debit Note contains the quantity of goods returned and reasons for return of goods. The buyer makes out two copies of Debit Note. One copy is retained and the other copy is sent to the seller along with goods. On the basis of the copy retained, the buyer records this transaction in his 'Purchases returns Journal'. The ruling of this book is identical with the ruling of purchase Journal.

Imran Electronics becomes creditor for Rs. 50,000. Then he is debited with Rs. 10,000.

Suppose on 12.1.1991 Saleem purchased 50 radio sets @ Rs. 1,000 from Imran Electronics on credit. On receiving the goods, Saleem finds that 10 radio sets are of inferior quality. Saleem returns, these sets to the seller and sends him a debit note. The debit note is given below:

Debit Note

Telephone............................ No..................

Date.................

From: Saleem

To: Imran Electronics, Hall Road, Lahore.

We are debiting your account with the value of under mentioned sets returned to you for the reason stated below. We are waiting for a Credit Note.

Date	Particulars	Details Rs.	Amount Rs.
14.1.91	10 radio sets @ Rs. 1000 as per invoice		
	No........ dated 12.1.91	10,000	
	Less Trade discount	Nil.	
	Returned --goods being of inferior quality		10,000

E. & O.E.

Signature

Now this debit note is entered in the Purchases Returns Journal in the following way,

Purchases Returns Journal

Date	Description	Invoice No.	L/F	Details Rs.	Amount Rs.
14.1.91	Imran Electronics 10 radio sets @ Rs. 1,000 Less trade discount Goods returned being of inferior quality	–	CL.12	10,000 NIL.	 10,000

NOTE:

From Purchases Returns Journal posting will be made in two accounts in the ledger, Imran Electronics account will be debited and purchase returns account will be given credit

ILLUSTRATION NO. 3 SL

Enter the following transactions in the Purchases Returns Journal and post them to the ledger accounts:

Jan. 5, 1991, Returned to Sunshine Biscuit Co.,

10 cases of biscuits @ Rs. 125 per case for damage in transit.

Jan. 18, 1991, Returned to Salman Stores,

3 bags of sugar @ Rs 500 per bag for not according to order.

Jan. 26, 1991, Returned to Punjab Flour Mills,

10 bags of flour @ Rs. 200 per bag for not according to specification, less discount 5%

Solution:

PURCHASES RETURNS JOURNAL (BOOK)

Date	Description	Debit Note No.	L/F	Details Rs.	Amount Rs.
5.1.91	**Sunshine Biscuit Co.** 10 cases of biscuits @ Rs. 125 per case (Being damaged in transit)	....	CL. 8	1250	1250
18.1.91	**Salman Stores** 3 bags of sugar @ Rs. 500/ bag (Not according to order)	....	CL. 12	1500	1500
26.1.91	**Punjab Flour Mills** 10 bags of flour @ Rs. 200 bag Less discount 5% (Not according to specification)	....	CL 16	2000 100	 1900
31.1.91	**Purchase Returns A/c Cr.**		GL. 18		4650

Sunshine Biscuit Co. A/C (Folio 8)

5.1.91	Purchase Return A/c	Rs. 1250		Balance b/d	Rs. 10000

Salman Stores A/C (Folio 12)

18.1.91	Purchase Return A/c	Rs. 1500		Balance b/d	Rs. 8000

Punjab Flour Mills A/c (Folio 16)

26.1.91	Purchase Return A/c	Rs. 1900		Balance b/d	Rs. 15000

Purchase Return A/c (Folio 18)

		Rs.	31.1.91	Sundry Creditors (Total returns for the month)	Rs. 4650

It must be noted that, the balances are respectively placed on the credit sides of the accounts of the creditors to make them more realistic. It shows that they i.e. Sunshine Biscuit Co., Salman Stores, Punjab Flour Mills were creditors of the business for Rs. 10,000, 8,000, 15,000 respectively. Now their accounts have been debited with Rs. 1,250, 1,500 and 1,900 respectively and they are now creditors of the business for Rs. 8,750, 6,500 and 13,100 respectively. On the other hand the Purchases Returns account has not been credited thrice on three different dates. Instead it has been credited with the total amount of three transactions aggregating Rs. 4650 (1250 + 1500 + 900), at a time at the end of the month.

SUBDIVISION OF JOURNAL:

How the transactions are entered in Special Journals and posted to the Ledger?

Documents for sales and purchases--the invoice:

PURCHASES JOURNAL:

Distinction Between Purchases Journal and Purchases Account.

SALES JOURNAL (BOOK):

PURCHASES RETURNS OR RETURNS OUTWARD JOURNAL

RULES FOR POSTING THE PURCHASES RETURNS JOURNAL:

Debit the personal accounts of the creditors to whom the goods are returned.

Credit the Purchase Returns Account with the total returns for the month.

SALES RETURNS JOURNAL (BOOK)

A seller must expect in the course of business that some of his customers (buyers) will return goods for some solid reasons (wrong colour, wrong size, not according to specification, imperfectly finished etc). When a debit note (already discussed) is received, along with the goods returned from the buyer (customer) it is a claim on the seller. If this claim is accepted by the seller then he makes out a 'Credit Note' in duplicate. It is usually printed in red ink, signifying that the customer's claim has been accepted and his account has been given the required credit. The top copy is sent to the buyer who has returned the goods. The second copy is given to the clerk in the Accounts Department, who enters it into the 'Sales Returns Journal.'

Take the same example as we have discussed in the previous topic (Purchases Returns Journal). Suppose on 12.1.1991 Saleem purchased 50 radio sets @ Rs. 1,000 from Imran Electronics on credit. On 14.1.1991, Saleem finds that 10 radio sets are of inferior quality. Saleem returns these sets to Imran Electronics and sends them a debit note. On receiving the debit note from Saleem, the seller makes out a credit note, in duplicate and sends the top copy to the buyer (Saleem). The second copy is sent to the Accounts Department and is entered in the 'Sales Returns Journal'. The credit note is given below:

Credit Note

Telephone........... No..............

From: Imran Electronics (sender) Date ....

To : Saleem (to whom the note is sent)

We are crediting your account with the value of under mentioned radio sets received from you for the reason stated as in your Debit Note No......

Date	Particulars	Details Rs.	Amount Rs.
15.1.1991	10 radio sets @ Rs.1000/radio as per D.N. No. 37 dated 14.1.1991.	10,000	
	Less Discount Nil.	Nil	
	Returned (goods being of inferior quality	——	10,000

E & O.E.

(Signature)

The credit note is entered in the Sales Returns Journal in the following way,

SALES RETURNS JOURNAL

Date	Description	Credit Note No.	L/F	Details Rs.	Amount Rs.
15.1.91	**Saleem** 10 radio sets @ Rs. 1,000/ radio. Returned (goods being of inferior quality).	——	CL. 15	10000	10000

NOTE: From Sales Returns Journal, posting will be made on the credit side of Saleem (Debtor) account and on the debit side of the Sales Returns account in the ledger.

ILLUSTRATION NO. 4 SL

Enter the following transactions in Sales Returns or Returns Inward Journal and post them to the appropriate ledger accounts.

Feb. 3, 1991. Received back from Qasim Bros.

5 bundles of shirts @ Rs. 2,000 per bundle for inferior quality. Less Trade discount 10%.

Feb 10, 1991, Mr. Ali returned 10 bales of cloth

@ Rs. 2,500 per bale for not according to order.

Feb. 27, 1991, Returned by M. Rafiq 25 pairs of socks @ Rs. 20 per pair for wrong size.

Less discount 10%.

Solution:

SALES RETURNS JOURNAL

Date	Description	Credit Note No.	L/F	Details Rs.	Amount Rs.
3.2.1991	**Qasim Bros.**				
	5 bundles of shirts @ Rs. 2,000 per bundle.	....	DL. 15	10000	
	Less Trade Discount 10%			1000	9000
	(Goods being of inferior quality)				
10.2.1991	Mr. Ali				
	10 bales of cloth @ Rs. 2,500 per bale:	....	DL. 19	25000	25000
	(Goods being not according to order).				
27.2.1991	M. Rafiq				
	25 pairs of socks @ Rs. 20/ pair	....	DL. 25	500	
	Less 10% discount.			50	450
	(Being goods not according to size).				
29 2.1991	Returns Inward A/c .... Dr.		GL. 30		34450

Qasim Bros. A/c (Folio 15)

	Balance b/d	40,000	3.2.1991	Sales Returns A/c	9000

Mr. Ali A/c (Folio 19)

	Balance b/d	80,000	10.2.1991	Sales Returns A/c	25000

Mr. Rafiq A/c (Folio 25)

	Balance b/d	5,000	27.2.1991	Sales Returns A/c	450

Returns Inward A/c (Folio 30)

29.2.1991	Sundry debtors (Total returns for the month)	34,450			

NOTE:

The balances are placed on the debit side of Qasim Bros., Mr. Ali and M. Rafiq accounts indicating that before return of the goods by them, they were debtors of the business for Rs. 40,000, 80,000 and 5,000 respectively. After the return of the goods by them, they became debtors of the business for Rs. 31,000, 55,000 and 4,100 respectively:

The Sales Returns Journal is the last of the four subsidiary books which deals with the movement of goods into and out of a business. But it should be remembered that only credit transactions relating to purchases, sales and returns of goods are recorded in these books.

Cash transactions relating to purchases, sales and returns of goods are recorded in Cash Book that will be discussed later on.

Transactions relating to purchases, sales and returns of other items excepting goods i.e. (machines, building, furniture etc.) are recorded in Journal Proper. Detailed discussion has been made later on about Journal Proper.

Table showing destination of transactions recorded in four special journals:

A table is given below showing posting of transactions relating to purchases, sales and returns of goods:

Transactions	Journal	Ledger
Credit purchases →	**Purchase Journal**	Dr. **General Ledger: Debit: Purchase A/c**
		Cr. **Creditors Ledger Crdit: Creditor's A/c**
Credit Sales →	**Sales Journal**	Dr. **Debtor's Ledger: Debit: Debtor's A/c**
		Cr. **General Ledger: Credit: Sales A/c**
Credit Purchases Returns →	Purchase Returns Journal	Dr. Creditors Ledger Debit: Creditors A/c
		Cr. General Ledger: Credit: Purchases Return A/c
Credit Sales Returns →	Sales Returns Journal	Dr. General Ledger: Debit: Sales Return A/c
		Cr. Debtor's Ledger Credit: Debtors A/c

TEST YOUR KNOWLEDGE

(1) Fill in the blanks:

(i) Credit purchases of goods are recorded in ...Purchase Journal.

(ii) Credit sales of goods are recorded in ...Sale... Journal.

(iii) Credit purchases of machinery are to be recorded in ......Purchase ..

(iv) Cash purchase of furniture and fixtures is to be recorded in ....Purch.

(v) Credit Note is the basis for recording ..Cal........ Book (Journal).

(vi) Debit Note is the basis for recording .... Book.

(vii) Invoice is the basis for recording ....Book (Journal)

(viii) Outward invoice is the basis for recording .... Book.

(ix) Rare transactions which do not fall within the scope of special journals are recorded in ....

Ans: *[(i) Purchase Journal (ii) Sales Journal (iii) Proper Journal (iv) Cash Book (v) Sales Returns Book (vi) Purchases Returns Book (vii) Purchase Journal (viii) Sales Journal (ix) Proper Journal]*

(2) In which book the following transactions are recorded:

(i) Purchase of plant for business on cash.

(ii) Purchase of patents on credit.

(iii) Purchase of goods on credit.

(iv) Purchase of goods on cash.

(v) Sale of finished goods on credit.

(vi) Sale of office building on cash.

(vii) Sale of old furniture on credit.

(viii) Sale of finished goods on cash.

(ix) Return of goods to the supplier.

(x) Goods returned by our customers.

Ans: *[(i) Cash Book (ii) Proper Journal (iii) Purchases Journal (iv) Cash Book (v) Sales Journal (vi) Cash Book (vii) Proper Journal (viii) Cash Book (ix) Returns Outwards Book (x) Returns Inwards Book]*

(3) Fill in the blanks with the word 'debit' or 'credit'.

(a) The total of Purchases Journal is posted to the .... of Purchase A/c.

(b) The total of Sales Journal is posted to the .... of Sales A/c.

(c) The total of Purchases Returns Journal is posted to the .... of Returns Outwards A/c

(d) The total of Sales Returns Journal is posted to the .... of Returns Inwards A/c.

(e) The entries in the Purchases Journal are posted to the .... of Creditors A/c.

(f) The entries in the Sales Journal are posted to the ....of Debtors A/c.

(g) The entries in the Purchases Returns Journal are posted to the .... of Creditors A/c.

(h) The entries in the Sales Returns Journal are posted to the .... of Debtors A/c.

Ans: *[(a) Debit (b) Credit (c) Credit (d) Debit (e) Credit (f) Debit (g) Debit (h) Credit]*

PROBLEMS

1. SL. Write up the Purchases Journal (Book) of Mr. Asif from the following particulars and show their posting into the ledger.

1991

Jan. 2 Bought of Saleem Plastic Co. Ltd. 12 dozens of plastic tubes @ Rs. 40 per dozen.

Jan. 5 Bought of Omroc Glass Co. 25 table glasses @ Rs. 20 each.

Jan. 10 Bought of Rafiq Ltd. 30 tables @ Rs. 80 each and 5 chairs @ Rs. 100 each.

Jan. 12 Bought of Imran & Sons 50 chairs @ Rs. 100 each less 10 % Trade Discount.

2. SL Give the ruling of the Sales Journal (Book) and record the following transactions therein. Also show the ledger postings.

1991

Feb. 2 Sold to Green Tea Co. Ltd. 3 chests of tea @ Rs. 200 per chest.

Feb. 4 Sold to Rafiq & Sons 100 kg of sugar @ Rs. 10 per Kg. Less 10 % Trade Discount.

Feb. 5 Sold to Zaidi Studio 10 dozen photo frames @ Rs. 15 per dozen.

3. SL From the following particulars write up the Sales Journal of Punjab Electric Co.

1991

March 2 Sold to Zafar Electric Store 200 pieces of 40 watts. bulb @ Rs. 5 per piece.

March 10 Sold to Asim & Sons 300 pieces of 60 W. bulb @ Rs. 7 per piece.

March 15 Sold to Lahore electric Co. 100 pieces of switch @ Rs. 4 per piece.

March 28 Sold to S.A. Electric Co. 50 pieces of Transistor @ Rs. 500 per piece. Less Trade Discount 10%

4. SL From the following particulars write the Purchases Returns Book and show the posting to the Ledger.

1991

Jan. 10 Returned goods to Sadiq & Sons, being of inferior quality, valued at Rs. 500.

Jan. 15 Returned goods to Lahore Stores, being not according to sample, valued at Rs. 1,000.

Jan. 18 Returned goods to Kalim & Co, being damaged in transit, valued at Rs. 800.

Jan. 25. Returned goods to Rana Stores, being not according to specification, valued at Rs. 400.

5. Enter the following transactions in the Sales Returns Journal (Returns Inward Book) and post them to the ledger accounts.

1991

April 3	Received back from Sohail & Co. 10 tables @ Rs. 100 per table for not according to specification.
April 12	Returned by K. Khalid an almirah valued at Rs. 600 for damaged in transit.
April 18	Received back from M. Ashraf 12 chairs @ Rs. 50 each for not according to order.
April 20	Returned by Waseem & Bros. a show-case valued at Rs. 1,000 for inferior quality.
April 26	Received back from M. Rauf a dressing-table valued at Rs. 900 for not according to design shown.

6. Enter the following transactions in the relevant subsidiary books (special journals) of a trader and post them in the ledger accounts.

(i) Purchased goods from Farid & Bros. Rs. 5,000.

(ii) Sold goods to X on credit Rs. 3,000.

(iii) Goods purchased from Farid & Bros. valued at Rs. 500 now returned to them being not according to sample.

(iv) Goods worth Rs. 500 sold to X now received back from him as these were found unsuitable.

(v) Purchased from Noor & Co. 100 kg. tea @ Rs. 30 per kg.

(vi) Sold to Naeem & Sons 30 kg. tea @ Rs. 40 per kg.

(vii) Returned by Naeem & Sons 10 kg. tea being not according to sample.

(viii) Returned 10 kg. tea to Noor & Co. being damaged.

CHAPTER - 8

CASH BOOK AND BANK RECONCILIATION STATEMENT

CASH BOOK AND BANK RECONCILIATION STATEMENT

We already know that a Ledger is a register in which the different accounts are kept. At least one page in this register is fixed for one account i.e. a page for Purchase A/c, a page for Sales A/c, a page for Salary A/c, a page for Rent A/c, a page for Cash A/c, etc.

As a business grows bigger and bigger, two problems arise for the businessman. Firstly, the ledger becomes thicker and thicker as more and more customers and creditors enter into business relationship with the firm. Secondly, some subdivision of work becomes necessary as it is impossible for one clerk to work with such a huge book.

A natural subdivision of the work occurs if we remove from the ledger the two busiest accounts of all, the **Cash account** and the **Bank account**. These two accounts are extremely active accounts: hardly a day goes by without hundreds of items being paid or received by a large-scale business. It, therefore, seems logical to remove these two accounts from the ledger and put them into a separate book in the special charge of one person, called the 'cashier'. Of all the valuable items in which a business deals, cash is the most easily misappropriated item. Many small businessmen try to keep the control of the cash themselves. If this is not possible, the cashier may be a trustworthy employee, whose reliability is beyond doubt. Even then it is usual to take precautions against defalcation.

In previous chapters, we have discussed that under double entry system all transactions (including cash transactions) are first recorded in journal and thereafter posted to the two concerned accounts in the ledger (including cash A/c. But in practice cash transactions are not recorded in the journal and no cash A/c is opened in the Ledger. Instead of it, a separate book named "Cash Book" is maintained for recording cash transactions. Cash transactions are primarily recorded in 'Cash Book' instead of journal and thereafter the non-cash aspect of the transaction is posted in the concerned account in the Ledger. As for cash aspect of the transaction is concerned no posting to Cash A/c in the Ledger is necessary, since the Cash Book itself serves the purpose of Cash A/c. So Cash A/c is not opened in the Ledger. For example, goods sold for cash Rs. 1,000. Its cash aspect is recorded in 'Cash Book' which serves the purpose of both the Journal and the Ledger. Thus cash aspect is only recorded in the Cash Book but not in Cash A/c in the Ledger. But on the other hand the non-cash aspect of transaction (sales) is also posted to Sales A/c in the Ledger.

The Cash Book is written more or less on the line of a Cash A/c in the Ledger. It has two similar sides like a ledger account the left hand side is called debit side and the right hand side is called credit side. The balance of the two sides indicates cash in hand. Thus 'Cash Book' is practically a substitute for Cash A/c in the Ledger.

DEFINITION:

The book in which all cash transactions (either cash is received or paid) are primarily recorded according to dates, is called 'Cash Book'.

FEATURES:

A Cash Book has the following features:

(1) It plays a dual role. It is both a book of original entry as well as a book of final entry. All cash transactions are primarily recorded in it as soon as they take place; so it is a journal (a book of original entry). On the other hand, the cash aspect of all cash transactions is finally recorded in the Cash Book (no posting in Ledger); so a Cash Book is also a Ledger (a book of final entry).

(2) Only one aspect of cash transaction is posted to the ledger account. The other aspect (i.e. cash aspect) needs no posting in Cash A/c. Since the Cash Book is the substitute for Cash A/c, no Cash A/c is opened in the ledger.

(3) It has two identical sides--left hand side, the debit side and right hand side, the credit side.

(4) All the items of cash receipts are recorded on the left hand side and all items of cash payments on the right hand side in order of date.

(5) The difference between the total of two sides shows cash in hand.

(6) Its balance is verified by counting actual cash in the cash box.

(7) It always shows debit balance. It can never show credit balance.

ADVANTAGES:

Generally cash transactions are numerous. What is credit transaction today, will be cash transactions tomorrow. In other words, all credit transactions are finally settled by cash. If like all other transactions cash transactions are also recorded primarily in Journal, the cash aspect of the transactions will be required to be posted to Cash A/C, in the Ledger separately. This involves much time and labour. This is why, cash transactions are recorded in a separate book named Cash Book. It saves much time and labour. Besides this the Cash Book renders the following benefits:

(1) Daily cash receipts and cash payments are easily ascertained.

(2) Cash in hand at any time can easily be ascertained through Cash Book balance.

(3) Any mistake in the book can be easily detected at the time of verification of cash.

(4) Any defalcation of money can be detected while verifying cash.

(5) Since cash is verified daily, Cash Book is always kept up-to-date.

Is Cash Book a Journal or a Ledger?

From the above discussion it appears that the Cash Book is the substitute for the Cash Account. In fact, no separate Cash Account is opened in the Ledger, Cash Book serves the purpose of the Cash Account. The entries in Cash Book are regarded as one aspect of the Double Entry System - the other aspect is posted to the Ledger in the concerned account. L.C. Cropper remarked "Every entry in the Cash Book makes one half of a double entry; the other half of the double entry appears on the opposite side of some account in the Ledger." From this angle, 'Cash Book is a Ledger'.

On the other hand, all cash transactions are primarily recorded in the Cash Book in order of date and thereafter posted to the concerned ledger accounts. Judging from this angle, 'Cash Book is a Journal'. Thus we see that a Cash Book is the 'mixture of Journal and Ledger'. According to Spicer & Pegler, "the Cash Book is actually a ledger account, but owing to the large number of entries made therein, it is kept in a separate book, called a Cash Book, which is used also as a book of prime entry."

SPECIMEN OF A SIMPLE CASH BOOK:

Dr. Cr.

Date	Particulars	V. No.	L.F.	Amount Rs.	Date	Particulars	V. No.	L.F	Amount Rs.

THE COLUMNS OF A CASH BOOK ARE EXPLAINED BELOW:

1. DATE:

The date of transaction is written in this column in two lines--in the first line, the year and in the second line, the name of the month followed by the actual date.

2. PARTICULARS:

In this column the name of the opposite account is written (the second aspect of cash transaction). Below this is written the narration of the transaction.

3. L.F. (LEDGER FOLIO):

The page number of the Ledger where the concerned (opposite) account has been opened, is written in this column. This will help to locate the account from the Ledger. It may be noted that in a Ledger account J.F. is written as reference, while in a Cash Book L.F. is written. It is so, because cash transactions are not recorded in any Journal.

4. AMOUNT:

The amount of the transaction is recorded in this column. The amount of cash received is recorded on the debit side in amount column and the amount of cash paid is recorded on the credit side in amount column.

5. V. NO. (VOUCHER NUMBER):

The voucher number of each item of receipt and payment is also written. A voucher is necessary for each item of receipt and payment. Generally, a voucher has a serial number and this number is written in this column (V. No).

When cash is received from a debtor or customer, generally a receipt or 'cash memo' is issued to the debtor which is called Receipt Voucher. Again, when money is paid to a creditor or supplier a receipt is obtained from him which is called 'Payment Voucher, Cash transactions are recorded in the Cash Book on the basis of Receipt Voucher and Payment Voucher.

Thus, a document evidencing cash receipts and payments and forming the basis for making entries in the Cash Book is called Cash Voucher.

DISTINCTION BETWEEN A CASH BOOK AND A CASH ACCOUNT

In fact, Cash Book is a substitute for a Cash Account. Yet there are some differences between the two, which are given below:

Cash Book	Cash Account
1. It is a separate book in which cash transactions are directly recorded.	1. It is an account in a Ledger in which posting is made from journal.
2. It serves the purpose of both journal and ledger and hence cash transactions need not be primarily recorded in Journal.	2. It serves the purpose of a Ledger only. If Cash A/C is opened in the Ledger, all cash transactions are first recorded in journal.
3. Narration is required.	3. Narration is not required.
4. A column for Ledger Folio is provided.	4. A column for Journal Folio is provided.

TYPES OF CASH BOOK:

At the beginning of this chapter we have discussed that the Cash Account and the Bank Account are two busiest accounts in a Ledger and it will be logical to remove these two accounts from the Ledger to reduce the volume of the Ledger. We have seen that how Cash A/C is removed from the Ledger and instead of it, a Cash Book is maintained to record the cash transactions. How a Bank A/C is removed from the Ledger and where the bank transactions are recorded? It will be discussed under this topic 'Types or Classes of Cash Book'.

We must have a clear idea about transactions with a bank before we discuss about different classes of a Cash Book. In all business concerns cash transactions are numerous. Cash transactions may take place in the following two ways:

(i) By Cash

(ii) By Cheque

Transactions in cash have been discussed in details in this chapter. So here we discuss about the transactions by cheque. Transactions involving large sums usually take place by cheques. Now let us see what we actually mean by transactions by cheques.

OPENING AN ACCOUNT WITH A BANK:

Usually all concerns except a few small ones, open an account with a bank. Opening an account with a bank means that a sum of money is kept deposited with a bank and that money can be withdrawn by a cheque at any time as and when required. There are three types of accounts that may be opened with a bank:

(i) PLS Saving Account

(ii) Current Account

(iii) Fixed Deposit Account

Most of the concerns open current account with the bank, because there is no restriction as to the number and amount of withdrawals of money like PLS saving account. In other words, if current account is kept with a bank, the depositor (account holder) can withdraw the money at his will up to the limit of his deposits with the bank. Generally no interest is allowed on deposit with the bank under current account.

How an Account is Opened with a Bank?

To open an account the depositor will have to apply to the bank in the prescribed form and deposit a sum of money. Immediately the bank will open an account in the name of the depositor in his Ledger and credit it with the amount of deposit. Thereafter. the bank will give the depositor the following three books:

1. PASS BOOK

Pass Book is a copy of the depositor's account in the bank's ledger which is provided to the depositor. This book is written by the bank, but kept with the depositor. On different dates, the depositor submits the Pass Book to the bank and the bank in turn returns it to the depositor after recording the transactions in it from its Ledger. The depositor can ascertain his bank balance at a glance at any time from this book.

2. PAYING-IN-SLIP BOOK

The money is deposited by the account holder into the bank with the help of this book.

3. CHEQUE BOOK

Whenever the depositor wants to draw money from the bank, he signs the cheque and hands it over to the bank. This is known as 'drawing a cheque'. The bank pays the sum of money mentioned in the cheque to the depositor or to his nominee and immediately debits the account of the depositor.

Thus money can be deposited into the bank by means of paying-in-slip and withdrawn by means of a cheque. A cheque may be issued to a creditor instead of paying him cash. On the other hand, we may also receive cheque from our debtors instead of cash.

ADVANTAGES OF OPENING AN ACCOUNT WITH A BANK:

The following advantages are obtained by opening a bank account.

1. Money is kept safe--there is no risk of theft or dacoity.
2. Transaction through a cheque is very convenient and the risk is reduced to a greater extent.
3. Loan may be taken from the bank in case of need.
4. Money can be remitted from one place to another place very quickly and at reduced cost.
5. Bank pays insurance premium, house rent etc. and collects dividend and interest on investment (Government securities, shares, bonds) on behalf of its account holders.
6. Bank enables its customers to buy goods on credit through Letter of Credit.
7. Valuable documents and investments can be kept deposited in the safe custody of the bank.

ACCOUNTING TREATMENT OF CHEQUES:

1. CHEQUES RECEIVED FROM DEBTOR:

When we receive cheques from our debtor, we may adopt the following three options:

(i) Deposit with bank.

(ii) Endorse to a creditor.

(iii) Encash over the counter of debtor's bank.

(i) Deposit with bank:

When a cheque is received from a debtor, it may be deposited with the bank for collection from the debtor's bank after recording its details in Paying-in-slip Book. The bank will collect the amount of cheque from the concerned (debtor's) bank and credit it to the account of its customer. Suppose we receive a cheque from our debtor Mr. X for Rs. 1,000 on 5. 6. 1991 and deposit it into our bank for collection on the same date. The following entry will be passed in our books.

5.6.1991

Bank A/c....................................Dr. 1,000

Mr. X A/c..1,000

(Being cheque received and deposited into bank)

NOTE:

This entry shows increase in our bank balance (an asset) and decrease in our debtor (an asset).

But if for any reason the cheque cannot be deposited on the same day i.e. 5.6.1991, the cheque will be kept in cash box and will be assumed as a part of cash. i.e. so Cash A/c will be debited instead of Bank A/c. On the later date the cheque will be taken out of the cash box and deposited into the bank. Suppose, the cheque received on 5.6.1991, deposited on 8.6.1991. The entries will be:

5.6.1991

Cash A/c ....Dr. 1,000

Mr. X A/c.................................1,000

(Being cheque received)

8.6.1991

Bank A/c..................................Dr. 1,000

Cash A/c 1,000

(Being cheque deposited into bank)

Generally the bank does not charge anything for this service (collection of our cheques). But if a cheque received from a debtor of a distant place (an outstation cheque), the bank charges something. The bank deducts his charges from the amount of the cheque and credit the net amount to our account and the following entry will be passed in our books, if the bank charges Rs. 10.

10.6.1991.

Bank charges A/c..Dr. 10

Bank A/c...10

(Being collection charges deducted by the bank)

NOTE:

This entry shows increase in an expense and decrease in the bank balance (an asset). It means net increase in our bank balance is Rs. 990.

(ii) Endorsement to a creditor:

A cheque received from our debtor may be endorsed in favour of a creditor instead of depositing it with a bank. In that case the name of the creditor will be written on the back of the cheque under our signature. This process is known as "**Endorsement**". By this the creditor becomes the legal owner of the cheque and is entitled to receive the amount of the cheque. For example, suppose we receive a cheque for Rs. 1,000 from a debtor Mr. Saleem on 10.1.1991 and endorse it to our creditor Mr. Asif on 12.1.1991. The entries will be:

10.1.1991

Cash A/c ....Dr. 1,000

Mr. Saleem A/c..1,000

(Being cheque received)

12.1.1991.

Mr. Asif A/c..Dr. 1,000

Cash A/c...1,000

(Being cheque endorsed)

NOTE:

On 10.1.1991, the cheque has not been deposited into the bank, rather it is kept in the cash box, so Cash A/c is debited. On 12.1.1991, when the cheque is taken out of the cash box and endorsed to Mr. Asif, Cash A/c is credited. Thus the two entries show decrease in debtor (asset) and decrease in creditor (liability).

(iii) Encashment over the counter of the bank:

A cheque received from a debtor may be presented over the counter of debtor's bank and cash money is received against it. Suppose on 5.1.1991, we receive a cheque from our debtor K. Khan for Rs. 5,000 on Allied Bank Ltd. The Mall Lahore and we encash it over the counter of this bank. The following will be the entry:

5.1.1991

Cash A/c...........................Dr. 5,000

K. Khan A/c 5,000

(Being cheque received and encashed)

NOTE:

There will be no entry in Bank A/c, since there has been no change in the bank balance.

DISHONOUR OF CHEQUES:

Sometimes there may be a mistake in writing a cheque or the amount of deposit in Bank A/c may be less than the amount of cheque drawn. In such a case the bank will refuse to honour the cheque and the cheque is called 'dishonoured cheque'. The entries to be made in case of dishonour of cheque are given below:

1. CHEQUE RECEIVED FROM DEBTORS:

(i) If deposited into the bank and returned dishonoured:

Suppose on 5.1.1991 we receive a cheque from a debtor Mr. Sohail for Rs. 5,000 and is deposited into the bank for collection on the same date. But on 10.1.1991, the cheque is returned dishonoured by the bank and in turn we return it to Mr. Sohail. The following entries are passed in our books:

5.1.1991

Bank A/c ....Dr. 5,000

Mr. Sohail A/c.....................................5,000

(Being cheque received and deposited into the bank)

10.1.1991

Mr. Sohail A/c..........................Dr. 5,000

Bank A/c..5,000

(Being the cheque returned dishonoured)

NOTE:

The first entry shows that bank balance has increased and the account of the debtor has been settled (not remain debtor). The second entry shows that Mr. Sohail again has become debtor and the bank balance has reduced.

(ii) If endorsed to a creditor and returned dishonoured:

Suppose on 10.1.1991 we receive a cheque from Amjad for Rs. 1,000 and on 12.1.1991, we endorse it to our creditor Mr. Naeem. But on 15.1.1991, the cheque is dishonoured and received back from Mr. Naeem and we return it to Amjad. The following will be the entries:

10.1.1991

Cash A/c.................................... Dr. 1,000

Amjad A/c...1,000

(Being cheque received)

12.1.1991

Mr. Naeem A/c.................................Dr. 1,000

Cash A/c 1,000

(Being cheque endorsed)

15.1.1991

Amjad A/c.......................................Dr.1,000

Mr. Naeem A/c 1,000

(Being cheque returned dishonoured)

NOTE:

The last entry indicates that Amjad has become debtor and Mr. Naeem has become creditor again.

SOME SPECIAL BANKING TRANSACTIONS:

1. WHEN CASH IS DEPOSITED INTO The bank:

If cash is deposited into the bank, there will be decrease in our cash balance and increase in our bank balance. The following entry will be made:

Bank A/c...Dr.XX

Cash A/c...XX

2. WHEN CASH IS WITHDRAWN FROM THE BANK:

Cash may be withdrawn from the bank for the following two purposes:

(i) For business use:

If cash is withdrawn from the bank for business purposes, there will be increase in cash balance and decrease in bank balance. The following entry will be passed:

Cash A/c..............................Dr.

Bank A/c................................

(ii) For the private use of owner:

If cash is withdrawn from bank for the personal use of the owner, the following entry will be made:

Drawing A/c................................Dr.

Bank A/c ....

3. DIRECT DEPOSIT BY A DEBTOR TO BANK:

Sometimes, the debtors instead of paying money to us, directly deposit it to our bank account. Suppose on 10.9.1991, our debtor Mr. Hafeez has deposited Rs. 5,000 direct to our bank account. The following entry will be made:

10.1.1991

Bank A/c......................................Dr. 5,000

Mr. Hafeez A/c....................................5,000

(Being amount deposited into bank)

4. STOPPING PAYMENT OF CHEQUE ISSUED:

After issuing a cheque to a creditor we may stop its payment for certain reason. In that case we should issue instruction to the bank. This instruction is known as "stop order". On receiving the stop order, the bank will not honour the cheque if presented by the creditor and the entry passed on issuing the cheque will be reversed. Suppose on 1.1.1991 we issue a cheque for Rs. 5000 to our creditor Mr. Faisal and on 2.1.1991 we issue a stop order for the cheque. The following will be the entries:

1.1.1991

Mr. Faisal A/c..............................Dr. 5,000

Bank A/c 5,000

(Being cheque issued)

2.1.1991

Bank A/c .... Dr. 5000

Mr. Faisal A/c 5000

(Being payment of cheque stopped).

NOTE:

Stop order will not be effective, if the bank has paid the cheque before receiving such order. In case a cheque is lost or stolen, stop order is issued to the bank before somebody finds it and gets it encashed.

5. BANK CHARGES OR INCIDENTAL CHARGES:

Bank deducts certain amount from our bank A/c for services rendered by it to us. The entry will be:

Bank Charges A/c....................Dr, XX

Bank A/c....................................XX

NOTE:

This entry shows increase in an expense and decrease in our bank balance.

6. **BANK INTEREST:**

Bank allows us interest at a fixed rate on the amount lying deposited in Bank A/c. This interest is not paid in cash rather it is credited to our account (Transferred to our account). The entry will be:

Bank A/c............................Dr. XX

Interest A/c XX

NOTE:

The entry shows increase in our bank balance and increase in our revenue.

7. **STANDING ORDERS:**

Sometimes the bank pays some expenses on our behalf on fixed dates i.e.. insurance premium, house rent, office rent etc. as per our instructions. For example, the bank pays insurance premium Rs. 1,000 as per our instruction on 30.6.1991. The entry will be:

3.6.1991.

Insurance Premium A/c............................Dr.1,000

Bank A/c..1,000

Again on certain occasions the bank collects dividend on shares, interest on Government securities held by us and credit the amount to our account. For this the entry will be:

Bank A/c...............................Dr. XX

Dividend etc. A/c....................................XX

8. **INTEREST ON OVERDRAFT:**

Generally the bank does not allow withdrawal of money in excess of the deposit. But sometimes the bank may allow such withdrawal in special cases for the sake of depositor's goodwill. In that case our bank A/c will show credit balance and we will become debtor of the bank. Bank charges interest at fixed rate on the excess money (on overdraft). The following entry is made:

Interest A/c...........................Dr. XX

Bank A/c..................................XX

NOTE: This entry shows increase in our expense and decrease in our bank balance (or increase in our overdraft balance).

From the above given transactions, it may be noted that "Whenever there is increase in our bank balance, the bank account is debited and whenever there is decrease in our bank balance, the bank account is credited". It may be taken as a rule for recording all banking transactions in the cash book.

CLASSIFICATION OF CASH BOOK

Cash Book may be of following three types:

1. Simple or Single Column Cash Book.
2. Double Columns Cash Book.
3. Three or Treble Columns Cash Book.

1. SIMPLE OR SINGLE COLUMN CASH BOOK:

By cash we mean currency of notes.

It is a cash book in which only and only cash transactions are recorded. By single column we mean "one amount column" on each side of the Cash Book. One amount column on the debit side in which inflow of cash (cash received) is recorded and one amount column on the credit side in which outflow of cash (cash paid) is recorded. It is generally maintained by such business concerns which do not have bank accounts. (small business concerns).

We have discussed this book in detail at the beginning of this chapter.

BALANCING THE CASH BOOK:

The Cash Book is balanced in the same way as a ledger account. A Single Column Cash Book always shows debit balance (Debit side exceeding credit side) because more cash cannot be paid than what we have. To verify the accuracy of the Cash Book, it should be balanced daily (which may be shown in the Cash Book with red pencil). The balance as per the Cash Book must tally with the actual cash in the cash box. At the end of the period the Cash Book is finally balanced (showing debit balance) and the balance is put on the credit side for the purpose of closing the cash book. This balance will be transferred on the debit side of the Cash Book as opening balance of the next period.

ILLUSTRATION NO. 1 SL

Enter the following transactions in the cash book of Mr. Jamil.

1991.		**Rs.**
Jan. 1.	**Mr. Jamil started business with cash**	**1,00,000**
Jan. 3.	**Bought goods for cash**	**70,000**
Jan. 5.	**Paid for stationary**	**1,000**
Jan. 7.	**Sold goods for cash**	**40,000**
Jan. 10.	**Paid for trade expenses**	**1,000**
Jan. 11.	**Sold goods for cash**	**10,000**
Jan. 14	**Received cash from Mr. Asif**	**5,000**
Jan. 15.	**Paid cash to Mr. Qadir**	**10,000**
Jan. 18.	**Withdrew cash for personal use**	**3,000**
Jan. 22.	**Bought goods for cash**	**20,000**
Jan. 25.	**Sold goods for cash**	**45,000**
Jan. 27.	**Paid for electricity bill**	**2,000**
Jan. 31.	**Paid salary**	**5,000**
Jan. 31	**Paid rent**	**1,500**

Solution:

Dr. **CASH BOOK** Cr.

Date	Particulars	V/N	L/F	Amount Rs.	Date	Particular	V/N	L/F	Amount Rs.
1991					1991	Purchase A/c	----	----	70,000
Jan. 1	Capital A/c	----	----	100,000	Jan.3	(Being goods bought for cash)			
	(Being business started)								
Jan. 7	Sales A/c	----	----	40,000	Jan. 5	Stationery A/c	----	----	1000
	(Being goods sold)					(Being stationary purchased)			
Jan. 11	Sales A/c	----	----	10,000	Jan. 10	Trade expenses	----	----	1000
	(Being goods sold)					(Being expenses paid)			
Jan. 14	Mr. Asif A/c	----	----	5000	Jan. 15	Mr. Qadir A/c	----	----	10,000
	(Being cash received)					(Being cash paid)			
Jan. 25	Sales A/c	----	----	45000	Jan. 18	Drawing A/c	----	----	3000
	(Being goods sold)					(Cash drawn for personal use).			
					Jan. 22	Purchase A/c	----	----	20,000
						(Being goods bought)			
					Jan. 27	Electricity A/c	----	----	2000
						(Being bill paid)			
					Jan. 31	Salary A/c	----	----	5000
						(Being salary paid)			
					Jan. 31	Rent A/c	----	----	1500
						(Being rent paid			
					Jan. 31	Balance c/d	----	----	86500
				2,00,000					2,00,000
1991 Feb. 1	Balance b/d			86,500					

A single column Cash Book may also be used even if an account is to be opened in a bank. In such a case, a separate Bank A/c will be opened in Ledger where all bank transactions are posted from Cash Book and other subsidiary books. An illustration is given below:

ILLUSTRATION NO. 2 SL

Enter the following transactions in a Single Column Cash Book and prepare Bank A/c in ledger.

1991		Rs.
March 1	Cash in hand	40,000
March 1	Bank Balance	60,000
March 3	Received a cheque from Osman	12,000
March 4	Deposited Osman's cheque with bank	
March 8	Withdrawn from bank for business use	10,000
March 10	Goods sold for cash	15,000
March 15	Goods bought for cash	40,000
March 18	Goods sold for cash	30,000
March 20	Paid Rahim by cheque	13,000
March 30	Deposited into bank	8,000
March 31	Paid salary in cash	5,000
March 31	Paid rent by cheque	3,000

Solution:

Dr. **CASH BOOK (SINGLE COLUMN)** Cr.

Date	Particulars	V/N	L/F	Amount Rs.	Date	Particulars	V/N	L/F	Amount Rs.
1991					1991				
Mar. 1	Balance b/d	—	—	40,000	Mar. 4	Bank A/c (Being cheque deposited	—	—	12,000
" 3	Osman A/c (Being cheque received)	—	—	12,000	" 15	Purchase A/c (Being goods bought for cash)	—	—	40,000
" 8	Bank A/c (Being amount withdrawn)	—	—	10,000					
" 10	Sales A/c (Being goods sold for cash)	—	—	15,000	" 30	Bank A/c (Being cash deposited)	—	—	8,000
" 18	Sales A/c (Being goods sold for cash)	—	—	30,000	" 31	Salary A/c (Being salary paid)	—	—	5,000
					" 31	Balance c/d	—	—	42,000
				1,07,000					1,07,000
April 1	Balance b/d	—	—	42000					

NOTE:

Bank balance and transactions dated 20th March and 31st March are not recorded in Cash Book as they do not involve cash.

BANK ACCOUNT IN LEDGER

Dr. Cr.

Date	References	J/F	Amount Rs.	Date	References	J/F	Amount Rs.
1991				1991			
Mar.1	Balance b/d	—	60,000	Mar. 8	Cash A/c	—	10,000
" 4	Cash A/c	—	12,000	" 20	Rahim A/c	—	13,000
" 30	Cash A/c	—	8,000	" 31	Rent A/c	—	3,000
				" 31	Balance c/d	—	54,000
			80,000				80,000
April 1	Balance b/d	—	54,000				

DOUBLE COLUMN CASH BOOK

At the beginning of this chapter, it has been discussed that Cash A/c and Bank A/c are two busiest accounts in ledger and they should be removed from the ledger to reduce its volume and size. We have also discussed, how Cash A/c is removed from the ledger and instead of it the Cash Book is kept to record cash transactions.

In the same way no Bank A/c is opened in ledger for recording bank transactions, rather an additional amount column is provided on each side of 'Single Column Cash Book' for recording bank transactions. One more column for amount is provided on the debit side and one on credit side of Single Column Cash Book. These two amount columns on debit side and credit side will serve as Bank A/c and so it will not be necessary to open a Bank A/c in the ledger. The Cash Book having two Amount Columns on both sides is called 'Double Column Cash Book'.

ADVANTAGES:

The following advantages are derived from Double Column Cash Book.

1. All entries made in "Bank" Column of Double Column Cash Book form a part of double entry system and hence a separate Bank A/c need not be opened in ledger. It saves time, labour and cost.
2. Both cash transactions and bank transactions are recorded in the same book. So both cash balance and bank balance are easily available from the same book.

Thus it is said that the Double Column Cash Book has two accounts in it, the Cash A/c and the Bank A/c.

CONTRA ENTRY

In any account we can only have one half of a double entry. An account cannot be debited and credited at the same time. For example, when we sell goods for cash, cash received will be recorded on the debit side of Cash Book and the goods sold will be posted on the credit side of Sales A/c. But in Double Column Cash Book, we have two accounts, Cash A/c and the Bank A/c, so it is possible to have both a debit entry and a credit entry at the same time. For example, cash of Rs. 5,000 is deposited into the bank. In this transaction both Bank A/c and Cash A/c are involved and they will be recorded on both sides of Double Column Cash Book i.e. on the debit side in bank column and on the credit side in cash column.

Thus a transaction in which Cash A/c and Bank A/c are involved, is recorded on both the sides of Double Column Cash Book, it is called **"contra entry"**, from the Latin prefix contra meaning opposite to or against'.

In recording such a transaction the letter "C", is written in 'L.F' column because both aspects of the transactions are recorded and there is no need to post them into the ledger.

In this connection, the difference between contra entry and other entries in Cash Book may be noted. "The Double entry work of contra entry is completed in Cash Book. They need not be posted to ledger". But the double entry work of other entries in Cash Book is not completed (æ) one aspect (i.e. cash aspect) of the transaction is, however, completed in Cash Book, but the other aspect is not completed, which is to be posted to the concerned account in ledger.

CONTRA ENTRY WILL BE PASSED IN THE FOLLOWING CASES:

(1) When cash is deposited into the Bank.

Bank column - debit -- Cash column-credit.

(2) When cash is drawn from the bank for business purposes.

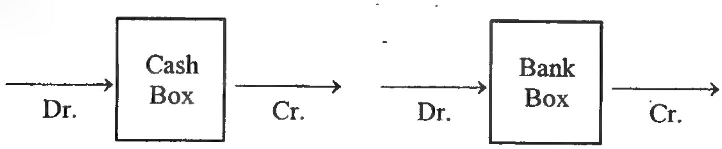
Cash Column - debit -- Bank column - credit.

(3) When a cheque received from a debtor on a date subsequent to its receipt is deposited into the bank.

Bank column - debit -- Cash column - credit.

MORE HINTS:

While writing Double Column Cash Book, keep in mind that there are two separate boxes - one for the cash and other for the bank:



When cash or cheques (Cheques received but not deposited on the same date) enters into cash box, Cash Column is debited and when cash or cheque goes out of the cash box, Cash Column is credited. On the other hand, when Cash or cheque enters into bank box, Bank Column is debited and when cash goes out of bank box, bank column is credited.

Now let us see how illustration No. 2 is recorded in Double Column Cash Book.

CASH BOOK (DOUBLE COLUMN)

Date	Particulars	V/N	L/F	Cash Rs.	Bank Rs.	Date	Particulars	V/N	L/F	Cash Rs.	Bank Rs.
1991 Mar. 1	Balance b/d	—	—	40,000	60,000	1991 March 4	Bank A/c (Being cheque deposited)	—	C	12,000	
" 3	Osman A/c (Being cheque received)	—	—	12,000		" 8	Cash A/c (Being cash withdrawn from bank)	—	C		10,000
" 4	Cash A/c (Cheque deposited with bank)	—	C		12,000	" 15	Purchase A/c (Being goods bought)	—	—	40,000	
" 8	Bank A/c (Being cash drawn from bank)	—	C	10,000		" 18	Cash A/c	—	C	8,000	
						" 20	Rahim A/c (Cheque issued)	—	—		13,000
" 10	Sales A/c (Being goods sold for cash)	—	—	15,000		" 31	Salary A/c (Being salary paid)	—	—	5,000	
" 18	Sales A/c (Being goods sold for cash)	—	—	30,000		" 31	Rent A/c (Being rent paid by cheque)	—	—		3,000
" 30	Cash A/c (Being cash deposited)	—	C		8,000	" 31	Balances c/d	—	—	42,000	54,000
			—	107000	80000					107000	80000
April 1	Balance b/d	—	—	42,000	54.000						

We can see from this illustration that how are the two illustrations showing the same result, cash balance Rs. 42,000 and Bank balance Rs. 54,000.

ILLUSTRATION NO. 3

Enter the following transactions of M. Rauf in a Double Column Cash Book and post them to concerned accounts in ledger:

		Rs.
1991		
Jan. 1	**Cash in hand**	**50,000**
Jan. 1	**Cash at Bank**	**30,000**
Jan. 3	**Cash Sales**	**20,000**
Jan. 4	**Paid M. Arshad by a cheque**	**7,000**
Jan. 6	**Received a cheque from Babar**	**4,000**
Jan. 8	**Cash deposited into bank**	**9,500**
Jan. 8	**Babar's cheque deposited into bank**	

Jan. 10	Drew from bank for office use	7,500
Jan. 11	Drew from bank for personal use of owner	12,000
Jan. 12	Cash purchases	28,500
Jan. 15	Received a cheque from S. Rashid	5,000
Jan. 16	S. Rashid's cheque endorsed to Shakeel	
Jan. 17	Paid Arshad Khan by a cheque	18,000
Jan. 18	S. Rashid's cheque returned dishonoured	
Jan. 19	Our cheque to Arshad Khan was dishonoured	
Jan. 21	Received interest from bank	700
Jan. 24	Cash sales	16,500
Jan. 27	Incidental charges debited by bank	350
Jan. 31	Salary paid by cheque	7,000

NOTE:

The solution of this illustration is provided on one page, so narrations relating to entries in Cash Book are ignored. Practically, in order to give plenty of room in the "Particulars Columns" a Cash Book is spread out across the whole double page -- one full page for debit side and one full page for credit side.

Solution:

CASH BOOK (DOUBLE COLUMN)

Date	Particulars	V/N	L/F	Cash Rs.	Bank Rs.	Date	Particulars	V/N	L/F	Cash Rs.	Bank Rs.
1991						1991					
Jan. 1	Balance b/d	—	—	50,000	30,000	Jan. 4	M. Arshad A/c	—	7		7,000
" 3	Sales A/c	—	5	20,000		" 8	Bank A/c	—	C	9,500	
" 6	1* Babar A/c	—	9	4,000		" 8	Bank A/c	—	C	4,000	
" 8	Cash A/c	—	C		9,500	" 10	Cash A/c	—	C		7,500
" 8	2* Cash A/c	—	C		4,000	" 11	Drawing A/c	—	11		12,000
" 10	Bank A/c	—	C	7,500		" 12	Purchase A/c	—	13	28,500	
" 15	3* S. Rashid's A/c	—	15	5,000		" 16	Shakeel A/c	—	16	5,000	
" 19	4* Arshad Khan A/c	—	17		18,000	" 17	Arshad Khan A/c	—	17		18,000
" 21	5* Interest A/c	—	19		700	" 27	Bank charges A/c	—	20		350
" 24	Sales A/c	—	5	16,500		" 31	Salary A/c	—	21		7,000
						" 31	Balances c/d	—		56,000	10,350
				103000	62200					103000	62200
Feb. 1	Balance b/d	—	—	56,000	10,350						

Explanation of entries marked above.

1.* On 6.1.1991, cheque received from Babar is treated as cash because it is not deposited into the bank on the same date.

2.* A contra entry is passed when Babar's cheque (which was treated as cash) is deposited into the bank on 8.1.1991.

3.* On 15.1.1991, cheque received from S. Rashid is treated as cash, so recorded in Cash Column.

4.* Cheque issued to Arshad Khan on 17.1.1991 is dishonoured, so the bank is debited again and Arshad Khan became a creditor again.

5.* On 21.1.1991, the bank allowed us interest which is revenue for the business and our bank balance is increased by Rs. 700.

NOTE:

The transaction on 18.1.1991 is not entered in the Cash Book because it does not involve cash A/c or Bank A/c. Simply S. Rashid will become debtor and Shakeel will become creditor again and entry will be passed in proper journal as:

18.1.91.	S. Rashid .... Dr.	5,000	
	Shakeel .... Cr.		5,000

Posting from Cash Book to concerned accounts in Ledger:

Cash A/c and Bank A/c have not been opened in Ledger.

For posting in Ledger, it will be very helpful to see the two columns on the debit side and credit side of the Cash Book first i.e. Particulars Column and L.F Column. On the debit side, in Particulars Column, the names of concerned accounts (accounts which are credited when Cash A/c or Bank A/c are debited) are given and in L.F Column, the page numbers on which these accounts are opened in Ledger are given. The concerned accounts on the debit side in Particulars Column are Sales A/c, Babar A/c, S. Rashid A/c, Arshad Khan A/c and Interest A/c and on the credit side M. Arshad A/c, Drawing A/c, Purchase A/c, Shakeel A/c, Arshad Khan A/c, Bank Charges A/c and Salary A/c.

RULE FOR POSTING

On credit side: of the concerned accounts in Particulars Column on the debit side of the Cash Book.

On debit side: of the concerned accounts in Particulars Column on the credit side of the Cash Book.

Folio means page number in Ledger.

Dr. **Sales A/c (Folio 5)** Cr.

		Rs.
	3.1.1991: Cash A/c	20,000
	24.1.1991: Cash A/c	16,500

Dr. **Babar A/c (Folio 9)** Cr.

		Rs.
	6.1.1991 Cash A/c	4,000

S. Rashid A/c (Folio 15)

Dr.		Cr.	
			Rs.
		15.1.1991 Cash A/c	5,000

Interest A/c (Folio 19)

Dr.		Cr.	
			Rs.
		21.1.1991 Bank A/c	700

Arshad Khan A/c (Folio 17)

Dr.		Cr.	
			Rs.
17.1.1991 Bank A/c	18,000	19.1.91 Bank A/c	18,000

M. Arshad A/c (Folio 7)

Dr.		Cr.	
	Rs.		
4.1.1991	7,000		

Drawings A/c (Folio 11)

Dr.		Cr.	
	Rs.		
11.1.1991	12,000		

Purchase A/c (Folio 10)

Dr.		Cr.	
	Rs.		
12.1.1991 Cash A/c	28,500		

Shakeel A/c (Folio 16)

Dr.		Cr.	
	Rs.		
16.1.1991 Cash A/c	5,000		

Bank Charges A/c (Folio 20)

Dr.		Cr.	
	Rs.		
27.1.1991 Bank A/c	350		

Salary A/c (Folio 21)

Dr.		Cr.	
	Rs.		
31.1.1991 Bank A/c	7,000		

TREBLE OR THREE COLUMN CASH BOOK:

We know, when cash is received from the debtors, discount may be allowed to them. And when cash is paid to creditors, discount may be received from them. It means the cash and the discount are very much related to each other. Another interesting thing is that when the cash is received, the discount is allowed and both cash account and discount account are debited. On the other hand, when the cash is paid, the discount is received and both the cash account and the discount account are credited in the books of account. Thus in ***"Double Column Cash Book another 'amount' column is provided on each side to record discount allowed and discount received"***. It means the Cash Book now will have three "Amount Columns on each side, i.e. Cash Column, Bank Column and Discount Allowed Column on the debit side and Cash Column, Bank Column and Discount Received Column on the credit side.

It may also be noted that when 'Discount' Column is added with both sides of Double Column Cash Book it becomes a *"Treble or Three Column Cash Book"*.

It must be remembered that the Discount Column in Treble Column Cash Book is not an account. Both the Discount Allowed Account and Discount Received Account are opened in the ordinary Ledger. These columns are memorandum columns only; they help us remember how much discount has been allowed or received. The totals of discount allowed and discount received columns from two sides of Cash Book are posted in Discount Allowed A/c and Discount Received A/c respectively in the Ledger.

ILLUSTRATION NO. 4 SL

From the following particulars write up a Treble Column Cash Book of Mr. Naseem.

1990		**Rs.**
May 1:	**Cash in hand**	**20,000**
May 1:	**Cash at Bank**	**15,000**
May 3:	**Goods sold for cash**	**4,500**
May 5:	**Goods bought for cash**	**9,000**
May 8:	**Received a cheque from M. Farooq for Rs. 9650 in full settlement of his dues Rs. 9,800 and deposited into the bank.**	
May 11	**Paid to Zulfiqar Cash Rs. 5,000 and a cheque for Rs. 4,700 in full settlement of his dues Rs. 10,000**	
May 15.	**Cash received from M. Kaleem Rs. 4,900 in full settlement of his dues Rs. 5,000**	
May 17:	**Paid cash to Adnan Rs. 1,950 in full clearance of his dues Rs. 2,000**	
May 20:	**Received a cheque from Asim Tufail Rs. 3900 in full settlement of his dues Rs. 4,000**	
May 23:	**Asim Tufail's cheque endorsed to a creditor Akif in settlement of Rs. 4,050**	
May 25:	**Bank credited interest**	**500**
May 31:	**Bank debited bank charges**	**700**

Solution:

CASH BOOK (TREBLE COLUMN)

Dr. **Cr.**

Date	Particulars	V/N	L/F	Dis-allowed Rs.	Cash Rs.	Bank Rs.	Date	Particulars	V/N	L/F	Dis-received	Cash Rs.	Bank Rs.
1.5.90	Balances b/d	–	–		20000	15000	5.5.90	Purchase A/c	–	–		9000	
3.5.90	Sales A/c	–	–		4500		11.5.90	Zulfiqar A/c	–	–	300	5000	4700
8.5.90	M. Farooq A/c	–	–	150		9650	17.5.90	Adnan A/c	–	–	50	1950	
15.5.90	M. Kaleem A/c	–	–	100	4900		23.5.90	Akif A/c	–	–	150	3900	
20.5.90	Asim Tufail A/c	–	–	100	3900		31.5.90	Bank Charges A/c	–	–			700
25.5.90	Interest A/c	–	–			500	31.5.90	Balance c/d	–	–		13450	19750
				350	33300	25150					500	33300	25150

NOTE: The Discount columns are not balanced. The two Discount columns are simply totaled and posted to Discount Allowed A/c and Discount Received A/c in the Ledger.

Discount Allowed A/c

		Rs.			
31.5.1990	Sundry Discounts as per Cash Book	350			

Discount Received A/c

					Rs.
			31.5.1990	Sundry Discount as per Cash Book	500

ILLUSTRATION NO. 5 SL

From the following particulars of Bashir & Sons, prepare a Treble Column Cash Book for the month of April and post the entries from Cash Book to concerned accounts in the Ledger:

1991		Rs.
April 1	Cash in hand	40,000
April 1	Bank balance overdrawn (Cr. Balance)	10,000
April 2	Cash sales	25,000
April 3	Deposited into bank	30,000
April 5	Paid Haseeb by cheque	3,000
April 6	Issued order to the bank for stopping payment of cheque issued to Haseeb	
April 8	Received a cheque from Javed for Rs. 6,000 Less Cash Discount 5%	

April 12	Dividend collected by bank:	2,000
April 14	Received cheque for discount from Kabir and paid into the bank which was paid in full previously:	100
April 17	Rehman our customer deposited directly into bank	4,500
April 20	Paid salaries in cash	9,000
April 21	Paid office rent by cheque	3,000
April 23	Received a cheque from Ismat for Rs. 3,250 in full settlement of his account Rs. 3,300 and cashed the cheque over the counter.	
April 24	Bought furniture from Lahore Furnishers and paid Rs. 10,000 in cash and Rs. 7000 by cheque.	
April 26	Settled by cheque Salim's A/c	5,000
April 27	Our cheque to Salim was dishonoured	
April 30	Deposited into bank excess Cash over Rs. 10,700	

Solution:

CASH BOOK (TREBLE COLUMN)

Dr. **Cr.**

Date	Particulars	V/N	L/F	Dis- allowed Rs.	Cash Rs.	Bank Rs.	Date	Particulars	V/N	L/F	Dis-received Rs.	Cash Rs.	Bank Rs.
1991							1991						
April 1	Balance b/d				40000		April 1	[1]* Balance o/d b/d					10000
" 2	Sales A/c		3		25000		" 3	Bank A/c		C		30000	
" 3	Cash A/c		C			30000	" 5	Haseeb A/c		5			3000
" 6	Haseeb A/c		5			3000	" 14	[3]* Bank A/c		C	100		
" 8	[2]* Javed A/c		7	300	5700		" 20	Salary A/c		13		9000	
" 12	Dividend A/c		9			2000	" 21	Office Rent A/c		16			3000
" 14	[3]* Discount A/c		C			100	" 24	Furniture A/c		20		10000	7000
" 17	Rehman A/c		11			4500	" 26	Salim A/c		21			5000
" 23	Ismat A/c		18	50	3250		" 30	Bank A/c		C		14250	
" 27	Salim A/c		21			5000	" 30	Balance c/d				10700	30850
" 30	Cash A/c		C			14250							
				350	73950	58850					100	73950	58850
May 1	Balance b/d			10700	30850								

1.* Bank balance overdrawn (o/d) means we were debtors of the bank for Rs. 10000 because in the month of March, we drew Rs. 10,000 more than our deposits in the bank.

2.* On 8.4.91 we received a cheque from Javed which was treated as a part of cash.

3.* On 14.4.91, we received a cheque for discount from Kabir Rs. 100. To whom we have previously paid full amount in settlement when he agreed to allow us a discount of Rs. 100.

LEDGER

Sales A/c

			2.4.91	Cash A/c	25,000

Haseeb A/c

5.1.91	Bank A/c	3,000	6.4.91	Bank A/c	3,000

Javed A/c

			8.6.91	Cash A/c	5,700
				Discount A/c	300

Dividend A/c

			12.4.91	Bank A/c	2,000

Rehman A/c

			17.4.91	Bank A/c	4,500

Ismat A/c

			23.4.91	Cash A/c	3,250
				Discount A/c	50

Salim A/c

26.4.91	Bank A/c	5,000	27.4.91	Bank A/c	5,000

Salary A/c

20.4.91	Cash A/c	9,000			

Office Rent A/c

21.4.91	Bank A/c	3,000			

Furniture A/c

24.4.91	Cash A/c	10,000			
	Bank A/c	7,000			

Discount Allowed A/c

30.4.91	Sundry Discounts for the month as per Cash Book	350		

Discount Received A/c

		30.4.91	Sundry Discount for the month as per Cash Book.	100

BANK RECONCILIATION STATEMENT

It has already been discussed that in business we keep our 'Bank Account' in the Cash Book -- as a part of the Three Column Cash Book, i.e. Bank Account in the Cash Book means two bank columns on the both sides of two column or three column Cash Book. It is made up everyday, and we record in it (Bank Columns) all cheques received from our debtors and all cheques paid or issued to our creditors or suppliers. We shall also have several contra entries every month, recording excess cash paid in or cash drawn out when required for personal or office use. At the end of the month the Cash Book (Bank Column) is balanced and the result is a bank balance, (as per Cash Book). Thus the Cash Book (Bank Columns) tells us, what is our balance with the bank on a particular date.

In the same way, the bank also keeps a record of our bank account with the title "Depositor's Account" and enters into our account everyday what is paid in and what is drawn out. At the end of any day, the bank will gladly tell us our bank balance (as per bank record). So two reciprocal accounts are kept i.e. Bank Account (Cash Book) in books of the depositor and depositor's account in books of the bank. The balances shown by the two accounts (Bank A/c and Depositor's A/c) should be equal because when the Bank Account is debited (Bank Column of Cash Book is debited), the depositor's A/c is credited in the bank books and vice versa. In other words, for each transaction opposite entries are made in two books. So if the Cash Book (Bank Column) shows a debit balance, the depositor's account will show a credit balance and if the Cash Book shows a credit balance (overdrawn) the depositor's account in bank books will show a debit balance.

The rules for recording transactions in the Cash Book and in the bank books (Depositor's A/c) are as follows.

Deposits; When cash is deposited into the bank	**Depositor's Book** Debit = Bank A/c Credit = Cash A/c	**Bank's Book.** Debit = Cash A/c Credit = Depositor's A/c
Withdrawals; When Cash withdrawn from the bank	Debit = Cash A/c Credit = Bank A/c	Debit = Depositor's A/c Credit = Cash A/c

The balances of two accounts i.e. Bank A/c and Depositor's A/c will be clear from the following table:

Cash Book (Bank Column)	:	Debit Balance = Deposits with bank.
Cash Book (Bank Column)	:	Credit Balance = Bank overdraft.
Depositor's A/c	:	Debit Balance = Bank overdraft
Depositor's A/c	:	Credit Balance = Deposits with bank.

Usually a copy of Depositor's Account is provided by the bank to the depositor, which is called **"Pass Book"**. This book is written by the bank. After suitable intervals the depositor submits the Pass Book to the bank and the bank in turn returns it to the depositor after recording the transactions therein.

Sometimes, instead of providing a Pass Book to the depositor, at certain intervals, usually monthly, the bank sends each depositor a **'bank statement'**, which is a record of the beginning balance, any increase and decrease that have occurred since the previous statement and the ending balance of the depositor's account with the bank. The Pass Book and bank statement serve the same purpose to the depositor.

DISTINCTION BETWEEN CASH BOOK AND PASS BOOK

Although both the Cash Book and the Pass Book record the same transactions, yet there are some differences between the two, which are given below.

Cash Book (Bank Column)	Pass Book
1. It is written by the depositor.	1. It is written by the bank, but remains in depositor's possession.
2. Money deposited is recorded on the debit side and money withdrawn on credit side.	2. Money deposited is entered on the credit side and withdrawn on the debit side.
3. A cheque deposited for collection is recorded on the date of deposit.	3. It is recorded on the date when it is actually collected from the debtor's bank.
4. A cheque when issued to a creditor is recorded on the date of issue.	4. It is recorded when it is paid by the bank to the creditor.
5. Its debit balance shows cash at bank and credit balance shows bank overdraft.	5. Its debit balance shows bank overdraft and credit balance shows cash at bank.

ILLUSTRATION NO. 6

Enter the following transactions in the Cash Book and in the Pass Book.

1991		Rs.
Jan. 1.	S. Rizwan opened current account with Allied Bank Ltd. with	40,000
Jan. 3.	Paid Nayyar by cheque	4,000
Jan. 5.	Received a cheque from Shahid and deposited into the bank	8,000
Jan. 8.	Withdrew from bank for office use.	3,000
Jan. 10.	Paid rent by cheque	5,000
Jan. 14.	Bank charges debited by bank:	200
Jan. 17.	Paid Zafar by cheque	1,500

Solution:

Dr. **Cash Book (bank column only)** **Cr.**

Date	Particulars	V/N	L/F	Bank Rs.	Date	Particulars	V/N	L/F	Bank Rs.
1.1.91	Cash A/c		C	40,000	3.1.91	Nayyar A/c		7	4000
5.1.91	Shahid A/c		5	8000	8.1.91	Cash A/c		C	3000
					10.1.91	Rent A/c		9	5000
					14.1.91	Bank Charges A/c		11	200
					17.1.91	Zafar A/c		13	1500
						Balance c/d			34300
				48000					48000
18.1.91	Balance b/d			34300					

NOTE:

Only Bank Column on each side is shown in Cash Book. The Cash Column and Discount Column. have been ignored for the time being.

The Cash Book (Bank Column) is showing a debit balance of Rs. 34,300.

Pass Book (A copy of Depositor's A/c in Bank's Ledger)

A self balancing depositor's account.

Date	Particulars	Debit withdrawals	Credit Deposits	Dr. or Cr.	Balance
1991			Rs.		Rs.
Jan. 1.	Cash		40,000	Cr.	40,000
" " 3.	(Nayyar) cheque No.......	4,000		Cr.	36,000
" " 5.	Shahid (cheque No. (collected from Bank)......		8,000	Cr.	44,000
" " 8	Cash: Cheque No.	3,000		Cr.	41,000
" "10.	Cheque No. Paid	5,000		Cr.	36,000
" "14.	Bank charges:	200		Cr.	35,800
" " 17.	(Zafar) cheque No.	1,500		Cr.	34,300

It may be noted that the Cash Book (Bank A/c) is showing a debit balance (cash at bank) of Rs. 34,300 and the Pass Book (Depositor's A/c) is showing a credit balance of Rs. 34,300. Both balances are equal but opposite but generally these two balances do not agree.

WHAT IS MEANT BY 'RECONCILIATION'?

If there is a dispute between two friends, or they fail to agree about some matter, the disagreement may temporarily end the friendship between them. When they become friends again we say they have 'reconciled' with one another. Reconciliation is, therefore, resuming of friendly relations as a result of reasonable explanations between them.

In business we often have sets of figures (balances of Cash Book and Pass Book) which apparently disagree with one another, but reasonable explanations for the disagreement will reconcile the two sets of figures and show that, in fact, both are right.

There are three reasons why these figures (Cash Book balance and Pass Book balance) do not agree:

(a) One party may lack the knowledge of the transactions recorded by the other.

(b) There is always an unavoidable delay between one party doing something and the other party knowing about it.

(c) Errors and mistakes often occur.

If there is any discrepancy between the balance of Cash Book and that of Pass Book, the depositor prepares a statement to explain the causes of discrepancies and to reconcile the two balances. This statement of explanation is called **"Bank Reconciliation Statement".**

The idea of the Bank Reconciliation Statement is to discover the various things the bank has done in the Pass Book which the cashier was not aware of, put right anything that is wrong and draw up a logical explanation of the remaining differences, which are not wrong, but are delayed from being right by the time-lag.

This statement is generally prepared at the end of the month or the year and it is not necessary when there is no disagreement between the Pass Book and the Cash Book balances. One copy of this statement is also sent to the bank if the bank has made some errors or mistakes in the Pass Book.

The great advantage of preparing this statement is, if by mistake the Pass Book balance is shown less, the bank may wrongly dishonour our cheques for insufficiency of funds. As a result, the goodwill of the business will be suffered and our creditors will refuse to accept our cheques in future. By preparing this statement true bank balance can be ascertained.

Consider the following information, from an Electronics Dealer's Cash Book and his Pass Book.

Cash Book (Bank Column only)

Dr. Cr.

1991		Rs.	1991		Rs.
Jan. 1	Balance b/d	112500	Jan. 2	Rehman & Co.	23,800
Jan. 10	S. Anwar	25375	Jan. 14	Saleem & Sons.	14,250
Jan. 17	Mahmood H.	31310	Jan. 19	S. Sharif	18,350
Jan. 30	S. Zahid	36750			

A rough calculation shows that the balance on this Cash Book is Rs. 1,49,535 - a debit balance.

Pass Book (Dealer's A/c in Bank's Ledger)

Date 1991	Particulars	Dr. Rs.	Cr. Rs.	Balance Rs.
Jan. 1	Balance b/d			1,12,500
" 2.	Rehman & Co.	23,800		88,700
" 4.	Insurance paid (direct)	18,500		70,200
" 12.	S. Anwar		25,375	95,575
" 16.	Saleem & Co.	14,250		81,325
" 16.	Bank Charges	2,625		78,700
" 17.	Mahmood. H.		31,310	1,10,010
" 28.	Interest on bonds.		6290	1,16,300
" 30.	Interest paid as / standing order	14,000		1,02,300

A careful study of these two accounts will show:

1. The balances do not agree. Rs. 1,49,535 according to the Cash Book (Bank Column) and Rs. 1,02,300 according to the Pass Book (Dealer's A/c).
2. On 1.1.1991 both balances were in agreement, so the problem is quite recent (something has happened during this month.)
3. A cheque issued to S. Sharif on Jan. 19 has not been presented by him to the bank for payment. He may be a sole trader who only bothers to go to the bank once a week or so. On the other hand it may have been misplaced by him. This is one example of 'time-lag'.
4. S. Zahid's cheque, received on Jan. 30, has been paid in by the dealer but is not recorded in the Pass Book. This is another kind of time-lag; the bank probably has not collected this cheque from debtor's bank, so the dealer's account is not credited.
5. On Jan. 4, the Pass Book shows that the bank has paid insurance of Rs. 18,500 from dealer's account. The dealer is not aware that this has been paid by the bank, so it is not recorded in Cash Book.
6. On Jan. 16, the bank has charged the dealer Rs. 2,625 as bank charges. The dealer did not know this deduction from his account, so he did not record anything in the Cash Book.
7. On Jan. 28, the bank has received some interest on bonds on dealer's behalf. The dealer has not been told about this increase in his account, so it is not recorded in the Cash Book.
8. On Jan. 30, the bank has paid interest as per standing order on dealer's behalf.

(5), (6) (7) and (8) are examples of a lack of knowledge between the dealer and the bank.

The dealer did not know that the bank had taken away or received on his behalf, these amounts. (3) and (4) are examples of time lag (delay).

How to drown up a Bank Reconciliation Statement:

(a) Compare the two accounts and note all the items of disagreement, as we have done in (3) – (8) above.

(b) Adjust all the items in the cash book in the usual manner, which have not been recorded in its because of our lack of knowledge of what the bank have done.

(c) Reconcile the other items in a reasonable statement, starting with one balance and finishing with the other.

If we cannot reconcile them there must be some mistakes, either on our part or on the bank's part.

The Bank Reconciliation Statement will be prepared in the following way,

First of all a revised cash book is prepared;

REVISED CASH BOOK (BANK COLUMN ONLY)

Dr. **Cr.**

		Rs.			Rs.
1991			1991		
Jan. 1	Balance b/d	112500	Jan. 2	Rehman & Co.	23800
Jan. 10	S. Anwar	25375	Jan. 4	Insurance.	18500
Jan. 17	Mahmood H.	31310	Jan. 14	Saleem & Co.	14250
Jan. 28	Interest on bonds	6290	Jan. 16	Bank charges	2625
Jan. 30	S. Zahid	36750	Jan. 19	S. Sharif	18350
			Jan. 30	Interest	14000
			Jan. 31	Balance c/d	120700
		212225			212225
Feb. 4	Balance b/d	120700			

Bank Reconciliation statement is now prepared from the new (revised) Cash Book Balance in the following way.

(Starting from Cash Book Balance)

ELECTRONICS DEALER
Bank Reconciliation Statement
as on 31st Jan 1991

	Rs.
Balance as per Cash Book	120700
Add: back the cheque not yet presented for payment by the creditor to the bank	18350
	139050

Deduct the S. Zahid's cheque net yet collected by bank and so bank not credit our account — 36750

Balance as per Pass Book ⟶ Rs. 102300

'Starting with Pass Book Balance and finishing with Cash Book Balance:

ELECTRONICS DEALERS
Bank Reconciliation Statement
as on 31st Jan. 1991

	Rs.
Balance as per Pass Book	102300
Add: the S. Zahid's cheque not yet collected (because It has already been debited in Cash Book	36750
	139050
Deduct: the cheque paid to S. Sharif not yet presented (because it has already been credited in Cash Book)	18350
Balance as per Cash Book ⟶	120700

Thus the two balances are reconciled with each other.

DIFFERENT CAUSES OF DISAGREEMENT:

The students are advised to read these reasons for disagreement between two books very carefully.

1. CHEQUES ISSUED OR DRAWN TO CREDITORS BUT NOT PAID BY BANK:

Cash Book will show less Bank balance and Pass Book will show more.

When a cheque is issued to a creditor, it is recorded in the Cash Book (Bank credit column) on the same date, but bank will record it on the date when it is paid. In most of the cases a cheque cannot be presented for payment by the creditor on the date on which it is drawn. So long the cheque is not presented to the bank, the Cash Book balance and the Pass Book balance will differ, because the Cash Book was been credited but the Pass Book has not been debited. Suppose on 15.1.1990, we issue a cheque for Rs. 10,000 to a creditor Mr. X who presents it to the Bank on 19.1.1990 and the bank pays him the money. Here the Cash Book balance and Pass Book balance will show a difference of Rs. 10,000 during 15th Jan. to 19th Jan., 1990. For this, the Cash Book balance will be Rs. 10,000 less and the Pass Book balance Rs. 10,000 more.

2. CHEQUES DEPOSITED FOR COLLECTION BUT NOT YET COLLECTED AND CREDITED BY THE BANK:

Cash Book will show more bank balance and pass Book less.

When a cheque is received from a debtor, it is recorded in the Cash Book on the date, when it is deposited with the bank for collection. But the bank will record it in depositor's account on the date when it is actually collected by the bank from the concerned (debtor) bank. So long the bank cannot collect the amount, the Cash Book balance and the Pass Book balance will disagree. Suppose on 10.1.1990, we receive a cheque for Rs. 4000 from a debtor Mr. A and deposit it into the bank for collection on the same day after recording it in the Cash Book. But the bank has credited our account with the amount of the cheque when it is collected by it on 14.1.1990. So the Cash Book balance and the Pass Book balance will show a difference of Rs. 4000 during 10th to 14th Jan., 1990. **Thus the Cash Book balance will be Rs. 4000 more and the Pass Book balance Rs. 4000 less.**

3. AMOUNT DEPOSITED DIRECTLY INTO THE BANK BY THE DEBTORS:

Sometimes the debtors deposit the amount directly to our Bank A/c instead of paying cash to us. In such a case the bank will transfer the amount to our account (gives credit to our account) and sends us an intimation of this. But usually, there is some delay in receiving this intimation from the bank. So long the intimation is not received by us, the Cash Book balance and the Pass Book balance will disagree. For this, the **Cash Book will show less balance and the Pass Book will show more balance.**

4. DIVIDEND ETC. COLLECTED BY THE BANK:

Sometimes the bank collects and credits our account with dividend on shares, interest on Government securities etc. as per our instructions and sends an intimation to us. But it takes a few days to receive this intimation from the bank and we record it in Cash Book on the date of receipt of this intimation. For this, **the Cash Book will show less balance and the Pass Book will show more balance.**

5. INTEREST ON DEPOSITS:

The Bank allows us interest on our deposits and credits the amount of interest to our account and sends intimation to us. On receipt of the intimation, we record it in the Cash Book. So long the information is not received by us, the Cash Book balance and the Pass Book balance will not agree. For this, **Cash Book will show less balance and Pass Book will show more balance.**

6. INSURANCE PREMIUM ETC. PAID BY THE BANK:

Sometimes the bank pays insurance premium, factory rent, office rent, interest on debentures, trade subscription etc. on our behalf as per standing order. The Bank debits our accounts and sends intimation to us. On receipt of intimation from the bank, we record it in our Cash Book. **For this the Cash Book will show more balance and the Pass Book will show less balance.**

7. THE BANK CHARGES ETC. AND INTEREST ON OVERDRAFT:

Our account is debited with the bank charges and interest on overdraft and the intimation is sent to us by the bank. On receiving the intimation from the bank, we record them in the Cash Book. **For this the Cash Book will show more balance and the Pass Book will show less balance.**

8. ERRORS AND OMISSIONS:

The Cash Book balance and the Pass Book balance can also disagree if there is any error or mistake in the Cash Book or in the Pass Book. A few examples of such errors and omissions are given below;

8.(a) We have received a cheque from a debtor and recorded it in the Cash Book (debited in Cash Book) but have forgotten to sent it to the bank for collection. For such omission, **the Cash Book will show more balance and the Pass Book will show less balance.**

8.(b) We have received a cheque from a debtor and deposited it into the bank for collection but have forgotten to record it in the Cash Book. or wrongly recorded in the 'cash column' of the Cash Book or in "Bank column of Cash Book on 'credit side' instead of debit side. For such errors, **the Cash Book will show less balance and the Pass Book will show more balance.**

8.(c) We have received a cheque from a debtor, and deposited it into the bank and recorded it in the Cash Book, but the bank has forgotten to record it in the Pass Book or wrongly recorded it on the debit side (withdrawal side) of the Pass Book. **For such mistake, the Cash Book will show more balance and the Pass Book will show less balance.**

8.(d) We have issued a cheque to our creditor, but forgotten to record it in the Cash Book or wrongly recorded it in the Cash Column (credit column) of the Cash Book or in "Bank Column" of Cash Book on debit side. For this, **the Cash Book will show more balance and the Pass Book will show less balance.**

8.(e) We have issued a cheque to our creditor and the bank has paid the cheque but has forgotten to record it in the Pass Book. **For this the Cash Book will show less balance and the Pass Book will show more balance.**

8.(f) There may be a mistake in casting (Totaling) the Cash Book. Suppose the debit side of the Cash Book is overcast by Rs. 100 (Totaling is made more by Rs. 100). For this, **the Cash Book will show more balance and the Pass Book will show less balance.**

8.(g) On the other hand, if the credit side of the Cash Book is overcast, for this, **the Cash Book will show less balance and the Pass Book will show more balance.**

8.(h) If the bank has wrongly debited our account (Pass Book), for this, **the Cash Book will show more balance and the Pass Book will show less balance.**

8.(i) If the bank has wrongly credited our account (Pass Book), for this, **the Cash Book will show less balance and the Pass Book will show more balance.**

8.(j) We may have more than one accounts with the bank, e.g. Account No. 1188 and Account No. 1189. A cheque drawn on Account No. 1188 may be wrongly recorded in Account No. 1189 by the bank. In such a case for Account No. 1188, **the Cash Book will show less balance and the Pass Book of A/c No. 1188 will show more balance.**

8.(k) For the above mentioned error, **the Cash Book for A/c No. 1189 will show more balance and the Pass Book for A/c No. 1189 will show less balance.**

Now from the above discussed causes of disagreement, the following conclusion is drawn;

Due to cause No. 2, 6, 7, 8(a), 8(c), 8(d), 8(f), 8(h), 8(k):

Ist set of causes: {Cash Book shows — more balance; Pass Book shows — less balance}

Due to cause No. 1, 3, 4, 5, 8(b), 8(e), 8(g), 8(i), 8(j);

2nd set of causes: {Cash Book shows — less balance; Pass Book shows — more balance}

NOTE:

To prepare, a Bank Reconciliation statement the students should keep in mind the different causes of disagreement and their effect on the two balances.

A SUMMARY OF CAUSES OF DISAGREEMENT:

	Causes due to which, **Cash Book shows – more balance** **Pass Book shows – less balance**		Causes due to which, **Cash Book shows – less balance** **Pass Book shows – more balance**
2.	Cheques deposited but not yet credited by the bank in the Pass Book.	1.	Cheques Issued but not yet paid by the bank.
6.	Various expenses paid by the bank as per standing order.	3.	Amount deposited direct into the bank by the Debtors.
7.	Bank charges etc. and interest on overdraft charged to our account.	4.	Dividend etc., collected by the bank.
8.(a)	Cheque received and recorded in the Cash Book but go to sent to the bank.	5.	Interest on deposits credited to our account.
8.(c)	Cheques received, deposited into the bank and recorded in the Cash Book but the bank forgot to record in the Pass Book or wrongly recorded in the Pass Book on debit side.	8.(b)	Cheque received and deposited but omitted to record in the Cash Book or wrongly recorded in the Cash Column of the Cash Book or recorded in the bank column but on the credit side.
8.(d)	Cheque issued but omitted to record in the Cash Book or wrongly recorded in the Cash Column of the Cash Book or in the Bank Column but on the debit side.	8.(e)	Cheque issued and recorded in the Cash Book and the bank has paid the cheque but forgot to record it in the Pass Book.
8.(f)	Mistake in casting the debit side of the Cash Book (Bank Column).	8.(g)	Mistake in casting the credit side of the Cash Book (Bank Column).

8.(h) The Bank wrongly debited our account (Pass Book).	8.(i) The Bank wrongly credited our account (Pass Book).
8.(k) No Summary.	8.(j) No Summary.

RULES FOR PREPARING A BÅNK RECONCILIATION STATEMNT:

First of all the statement must be given a proper heading. The statement is usually prepared at the end of the month or the year, so the heading will be given in the following way.

Name of Business
Bank Reconciliation Statement
as on ....

The statement may be started with either the Cash Book balance or the Pass Book balance, but in examination, only one balance will be generally given to the students and the statement will be started with that balance. If it is started with the Cash Book balance, it will be finished with the Pass Book balance (the answer of the question) and If it is started with the Pass Book balance, it will be finished with the Cash Book balance.

After giving heading to the statement, the balance given to us should be written in the following way,

Balance as per .... book x x

Then causes of disagreement are added with or deducted from the starting balance to get the balance of the other book.

Cash Book means the bank columns:

Usually the Cash Book shows a debit balance (a favorable balance for depositor) and the Pass Book shows a credit balance (a favorable balance for depositor).

Now let us see if the Cash Book balance (debit balance) is given to us, the statement will be prepared in the following way,

NAME OF BUSINESS
Bank Reconciliation Statement
as on 31st Jan., ...

		Rs.	Rs.
	Balance as per Cash Book. Dr.		x x
Set No. 1 deducted	**Less:** Cause No. 2, 6, 7, 8(a), 8(c), 8(d), 8(f) and 8(h), 8(k), (provided any given in the Question)		x x
			x x
	Add: Cause No. 1, 3, 4, 5, 8(b), 8(e), 8(g), 8(i) and 8(j) (Provided any given in the Question)		x x
Set No. 2 added	(Answer). Balance as per Pass Book Cr.		x x

When the Pass Book balance (Cr.) is given in the question, the statement will be prepared in this way;

(Heading as given above)

		Details	Amount
		Rs.	Rs.
	Balance as per Pass Book. Cr.		x x
Set No.2 deducted	**Less:** Cause No. 1, 3, 4, 5, 8(b), 8(e), 8(g), 8(i) and 8(j) (Provided any given In question.		x x
			x x
	Add: Cause No. 2, 6, 7, 8(a), 8(c), 8(d), 8(f), 8(h) and 8(k). (Provided any given in the Question)		x x
Set No. 1 added	(Answer). Balance as per Cash Book Dr.		x x

NOTE:

The Bank Reconciliation statement is a statement showing causes of disagreement between the Cash Book balance and the Pass Book balance on a specific date, so while preparing it only those items should be considered which cause disagreement up to that specific date. For example, cheques for Rs. 2000 were paid into the bank for collection on 20th December, out of these Rs. 1100 were collected and credited on 25th December and the balance on 2nd January of next year. No doubt, all the cheques were collected but up to 31st December (when statement was prepared) collected cheques were only Rs. 1100 and un–collected cheques were Rs. 900 which caused disagreement between two balances, so cheques for Rs. 900 (being not collected) were considered only while preparing the statement.

ILLUSTRATION NO. 7

From the following particulars, prepare a Bank Reconciliation Statement of Mr. Naveed as on 31st Dec., 1990.

	Balance as per Cash Book Dr.	**32000**
1.	**Cheques deposited but not yet collected by bank. (cause No. 2)**	**20200**
2.	**Cheques issued but not yet paid by bank. (Cause No. 1)**	**13000**
3.	**Interest credited by bank but not recorded in Cash Book (Cause No. 5)**	**250**
4.	**Bank charges debited by bank but not entered in Cash Book (Cause No. 7)**	**50**

Solution:

MR. NAVEED
Bank Reconciliation Statement
as on 31st Dec., 1990

Cause No. 2, 7 are deducted and cause No. 1 and 5 are added to the cash Book balance

	Details Rs.	Amount Rs.
	Rs.	**Rs.**
Bank balance as per Cash Book. Dr.		32000
Less: Cheques deposited but not yet collected by the bank.	20200	
Bank charges debited in Pass Book	50	20250
		11750
Add: Cheques issued but not yet paid by the bank.	13000	
Interest credited by the bank in Pass Book	250	13250
Ans: The Balance as per Pass Book Cr. ⟶		25000

If the statement is started with Pass Book balance;

MR. NAVEED
Bank Reconciliation Statement
as on 31st Dec., 1990

Cause No. 1 are 5 are deducted and cause No. 2 and 7 are added to Pass Book balance

	Details Rs.	Amount Rs.
	Rs.	**Rs.**
Bank balance as per Pass Book. Cr.		25000
Less: Cheques issued but not yet paid by the bank	13,000	
Interest credited by the bank but not entered in the Cash Book:	250	13250
		11750
Add: Cheques deposited but not yet collected by the bank:	20200	
The Bank charges debited by the bank but not recorded in the Cash Book	50	20250
Ans: Balance as per Cash Book Dr. ⟶		32000

NOTE:

It may be noted from the above two statements that the causes of disagreement which are added in the first method are deducted in second method and vice versa.

ILLUSTRATION NO. 8

From the following particulars, prepare a Bank Reconciliation Statement as on 31st March, 1990 and arrive at the balance as per the Pass Book.

1. **On 31st March, 1990, the bank balance as per the Cash Book was Rs. 15000**
2. **The following cheques were deposited into the bank on 28th March but were not collected by the bank by 31st March,**

   (i) Rs. 500 (ii) Rs. 300 (iii) Rs. 200.
3. **The following cheques were issued but were not presented for the payment by 31st March.**

   (i) Rs. 200 (ii) Rs. 450 (iii) Rs. 525 (iv) Rs. 375.
4. **The bank credited a dividend of Rs. 2000 on 31st March but the intimation was received by the trader on 5th April 1990.**
5. **The bank credited interest of Rs. 50 on 31st March but not debited in Cash Book.**
6. **The Bank charged (debited) a Commission of Rs. 100 on 31st March.**
7. **A cheque of Rs. 500 was received from a customer and was entered in the bank column of Cash Book on 25th March, but was paid into the bank on 1st April.**

Solution:

BANK RECONCILIATION STATEMENT

as on 31st March, 1990

	Particulars	Rs.	Rs.
		Rs.	**Rs.**
Set No. 2 added	Bank balance as per Cash Book Dr.		15000
	Add: (1) Cheques issued but not presented till 31st March, 1990: (200 + 450 + 525 + 375)	1550	
	(2) Dividend credited only in Pass Book	2000	
	(3) Interest credited only in Pass Book	50	3600
			18600
Set No. 1 deducted	**Less:** (1) Cheques deposited in the bank but were not collected till 31st March: (500 + 300 + 200)	1000	
	(2) Bank commission debited only in Pass Book	100	
	(3) Cheques received from a customer and only debited in Cash Book:	500	1600
	Ans: Bank balance as per Pass Book Cr.		17000

ILLUSTRATION NO. 9

Prepare a Bank Reconciliation Statement of Mr. X as on 31st March, 1990 from the particulars given below;

(a) **Balance as per the Pass Book Cr. Rs. 30200**

(b) **Insurance premium of Rs. 1000 was directly paid by the bank for which there is no record in the Cash Book.**

(c) **Interest of Rs. 700 is credited by the bank in the Pass Book which is not recorded in the Cash Book.**

(d) **Cheques for a total amount of Rs. 20,000 were deposited into the bank in March but a cheque for Rs. 2500 out of them was credited in April.**

(e) **A cheque for Rs. 6500 was deposited into the bank in March but in April the cheque was returned by the bank as dishonoured.**

(f) **A cheque of Rs. 5000 was issued in March but it was not presented to the bank in the same month.**

Solution:

MR. X

BANK RECONCILIATION STATEMENT

as on 31st March, 1991

Rs. Rs.

		Rs.	**Rs.**
	Bank balance as per Pass Book Cr.		30200
Set No. 1 is added	**Add:** (1) Cheques deposited but not credited by bank till 31.3.1991	2500	
	(2) Cheques deposited but returned dishonored by bank	6500	
	(3) Insurance premium paid by bank but not recorded In Cash Book	1000	10,000
			40200
Set No. 2 is deducted	**Less:** (1) Cheques issued but not presented to the bank till 31.3.1991	5000	
	(2) Interest credited in Pass Book only	700	5700
	Ans: Bank Balance as per Cash Book Dr.		34500

NOTE:

A cheque received, deposited and returned dishonoured is adjusted in the same way as a cheque deposited but not collected.

Starting Bank Reconciliation statement with an "Overdraft Balance".

Overdraft balance means, Cash Book is showing credit balance (unfavourable to the depositor) and Pass Book is showing debit balance (unfavourable balance).

We have earlier discussed the two rules for preparing the statement when Cash Book balance (debit) and Pass Book balance (credit) are given. The rules were as follows:

Again, see the two sets of causes of disagreement

(1) Balance as per Cash Book (Dr.)

Less: 1st set of causes from the balance

Add: 2nd set of causes to the balance.

(2) Balance as per Pass Book (Cr.)

Less: 2nd set of causes from the balance.

Add: 1st set of causes to the balance.

Now if the statement is started with the Cash Book balance (credit or overdraft), the rule is given as follows;

Opposite of the first rule:

(3) Balance as per Cash Book (Cr. or overdrawn)

Add: 1st set of causes to the balance

Less: 2nd set of causes from the balance.

Reverse of the rule No. 2

If statement is started with Pass Book balance (debit or overdrawn), the rule is exactly opposite to the rule No. 2.

(4) Balance as per Pass Book (Dr. or overdrawn)

Add: 2nd set of causes to the balance

Less: 1st set of causes from the balance

The following similarities may be noted in the four rules for addition or deduction;

(1) If the statement starts with:-

Bank balance as per Cash Book (Dr.)

OR

Bank overdraft as per Pass Book (Dr.)

The same rules for addition or deduction.

(2) If the statement starts with:-

Bank overdraft as per Cash Book (Cr.)

OR

Bank balance as per Pass Book (Cr.)

The same rules for addition or deduction.

ILLUSTRATION NO. 10

From the particulars given below, find out the balance, by means of a statement, that would appear in the Pass Book as on 31st December, 1991:

(1) Book overdraft as per Pass Book (Dr.) Rs. 1660

(2) Amount deposited directly into bank by a debtor Rs. 200 in December but not recorded in Cash Book.

(3) Interest on overdraft Rs. 40 and the Bank charges Rs. 20 are debited in Pass Book only.

(4) Cheques deposited but credited by the bank in the month of January, 1992 Rs. 800.

(5) Cheques drawn in December but presented in the month of January, 1992, Rs. 20,000, Rs. 1200 and Rs. 400.

Solution:

BANK RECONCILIATION STATEMENT

as on 31st December, 1991

Rule No. 1 is followed 2nd set of courses added add 1st set is deducted

	Rs.	Rs.
	Rs.	**Rs.**
Bank overdraft as per Pass Book		Dr. 1660
Add: (1) Cheques drawn but not represented at the bank till 31st Dec. (20000 + 1200 + 400)	21600	
(2) Amount deposited directly by a debtor but not recorded in the Cash Book	200	Dr. 21800
		Dr. 23460
Less: (1) Cheques deposited but credited by the bank in Jan., 1992.	800	
(2) Interest on overdraft debited only in Pass Book	40	
(3) Bank charges debited only in Pass Book	20	Cr. 860
Ans: Bank overdraft as per Cash Book (Cr.) Is Rs. 22600:		Dr. 22600

NOTE:

The statement is started with the Pass Book Debit balance (overdrawn) and also ended with the Pass Book debit balance Rs. 22600. Thus Debit balance Rs. 22600 of the Pass Book is equal to the credit balance of the Cash Book: (the answer of this illustration).

It may also be noted that in "amount" column, with every amount Dr. or Cr. is placed. e.g. Dr. 1660, Dr. 21800, Dr. 23460, Cr. 860 and Dr. 22600.

For student's convenience the method for writing 'Dr.' or 'Cr.' is given as follows.

We should see the starting balance, If it is a debit balance then, with every amount which is added to the starting balance, 'Dr.' will be placed and every amount which is deducted 'Cr.' will be placed. e.g. in the above illustration, starting balance is 'Dr.', so we placed 'Dr.' with the amount of causes (21800) and placed 'Cr.' with the amount of causes (860):

'Dr.' and 'Dr.' are added but 'Dr.' and 'Cr.' can never be added and vice versa.

ILLUSTRATION NO. 11

On 31st July, 1990, the Cash Book of a trader shows an overdraft balance (credit) of Rs. 4000. It is known from the comparison of the two books that out of the cheques amounting to Rs. 16000 and Rs. 38000 issued on 27.7.1990, cheque for Rs. 16000 was presented to the bank on 5.8.1990. He has deposited cheques amounting to Rs. 24000, Rs. 30,000, Rs. 4000 and Rs. 15000 in the last week of July, 1990. The first two cheques were collected by the bank within July, but the other two cheques were collected in August, 1990. The Pass Book shows a debit of Rs. 2000 in respect of interest, which is not recorded in the Cash Book within July, 1990.

Draw up a Bank Reconciliation Statement as on 31st July, 1990.

Solution:

BANK RECONCILIATION STATEMENT
as on 31.7.1990

Rule No. 2 is followed 1st set is added and 2nd set is deducted.

	Rs.	Rs.
	Rs.	**Rs.**
Bank overdraft as per Cash Book		Cr. 4000
Add: (1) Cheques deposited but not collected till the end of the July: (4000 + 15000)	19000	
(2) Interest debited in Pass Book only	2000	Cr. 21000
		Cr. 25000
Less: (1) Cheques issued but not presented till the end of the July:		Dr. 16000
		Cr. 9000
Ans: Bank overdraft as per Pass Book is Rs. 9000 (Dr.). Because Cash Book Cr. 9000 balance is equal to Pass Book Dr. 9000 balance.		

Statement Starts with an Overdrawn (unfavourable) Balance and ends with a Favourable Balance:

ILLUSTRATION NO. 12

From the following particulars, prepare a Bank Reconciliation Statement as on 31st December, 1991.

(1) Bank overdraft as per the Pass Book (Dr.) 6000

(2) Cheques amounting to Rs. 16000, Rs. 18000 and Rs. 20,000 issued during the month and a cheque for Rs. 18000 was presented to the bank on 2.1.1992.

(3) Cheques deposited into the bank are Rs. 24000, Rs. 30,000, Rs. 6000 and Rs. 20,000 in the last week of December, but of these cheques for Rs. 6000 and 20,000 were collected on 3.1.1992.

(4) Interest debited in the Pass Book Rs. 2000 but not recorded in the Cash Book.

Solution:

BANK RECONCILIATION STATEMENT

as on 31.12.1991

		Rs.	**Rs.**
		Rs.	**Rs.**
	Bank overdraft as per Pass Book		Dr. 6000
Rule No. 1 is applied.	**Add:** (1) Cheques issued but not presented at the bank up to 31st Dec.		Dr. 18000
			Dr. 24000
2nd set is added and 1st set is deducted	**Less:** (1) Cheques deposited but not collected by bank up to 31st Dec. (6000+2000)	26000	
	(2) Interest debited in Pass Book only	2000	Cr. 28000
	Ans: Balance as per Cash Book (Dr.)		Cr. 4000

NOTE:

The statement is started with (Dr.) overdrawn balance of the Pass Book but it ends with (Cr.) favourable balance of the Pass Book which is equal to the 'Dr.' balance (favourable) of the Cash Book.

Statement Starting with a favourable balance but ends with unfavourable (overdrawn) balance:

ILLUSTRATION NO. 13

Prepare a Bank Reconciliation Statement from the details given below as on 31st March, 1990.

(a) Bank balance of A/c No. 1 as per the Pass Book Rs. 10,000.

(b) Cheques deposited and credited by the bank but forgotten to be recorded in the Cash Book Rs. 17000.

(c) Unpresented cheques before 31.3.1990 Rs. 3000.

(d) Cheques issued against A/c No. 1 but wrongly debited to A/c No. 2 by the Bank Rs. 2000.

(e) Bills proceeds collected by the bank but not recorded is the Cash Book Rs. 2000.

(f) Insurance premium paid by the bank and debited in the Pass Book but not recorded in the Cash Book Rs. 4000.

(g) Interest on investment collected and credited by the bank on 26th March but recorded in the Cash Book on 31.3.1990 Rs. 1500.

(h) Debit side of the Cash Book (Bank column) was under cast by Rs. 1000.

(i) Cheques issued and paid by the bank but wrongly entered in the cash column of the Cash Book; Rs. 8000.

Solution:

BANK RECONCILIATION STATEMENT
as on 31.3.1990

Rule No. 2 is applied. Ist set is added and 2nd set is deducted

Rs. **Rs.**

	Rs.	**Rs.**
Bank balance as per Pass Book		Cr. 10,000
Add: (1) Insurance premium paid by bank but not recorded in Cash Book.	4000	
(a)* (2) Cheques issued but wrongly entered in the Cash Column of Cash Book.	8000	Cr. 12000
		Cr. 22000
Less: (b)* (1) Cheques deposited but not recorded in Cash Book.	17000	
(2) Cheques issued but not presented before 31.3.1990	3000	
(c)* (3) Cheques issued against A/c No. 1 but wrongly charged to A/c No. 2 by bank	2000	
(4) Bills collected and credited by bank but not recorded in Cash Book.	2000	
(d)* (5) Debit side of Cash Book under cast	1000	Dr. 25000
Ans: Bank overdrawn as per Cash Book.		Dr. 3000

(a)*: See cause No. 8(d) in summary of causes of disagreement.

(b)*: See cause No. 8(b) in summary of causes of disagreement.

(c)*: See cause No. 8(j) in summary of causes of disagreement.

(d)*: See cause No. 8(f) in summary of causes of disagreement.

NOTE:

An item No. g will not appear in the statement because it has been recorded in both the books up to 31.3.1990.

PREPARING STATEMENT WITH 'REVISED THE CASH BOOK' METHOD:

Accountants usually follow this – Revised Cash Book method to prepare Bank Reconciliation Statement. Under this method, first of all the Cash Book (bank column only) is revised by recording the Pass Book items like, bank charges, interest on overdraft, interest on investment, direct deposits by debtors, dividend collected payments etc. in the Cash Book as yet unrecorded in it. The errors and mistakes committed in the Cash Book are also rectified. After, the Cash Book is revised, the statement will be prepared the usual way and it will be started from the revised Cash Book balance (a new balance as per Cash Book). In this method, the reconciliation statement confines to the (i) unpresented cheques (ii) uncredited cheqeus (iii) Pass Book errors, If any.

ILLUSTRATION NO. 14

Shahid's Cash Book showed a bank overdraft of Rs. 15000 on 31st March, 1990. On Comparison of the two books, the following differences were noted down.

1. **An outstation cheque for Rs. 1400, lodged on 30th March, 1990 did not appear in the Pass Book.**
2. **Cheques issued to totaling Rs. 21000 had not been presented at the bank.**
3. **Interest on overdraft debited in the Pass Book was Rs. 200 but not recorded in the Cash Book.**
4. **Insurance premium paid and debited by the bank in the Pass Book Rs. 1000 but not entered in the Cash Book.**
5. **Interest on investment collected by the bank appeared in the Pass Book only Rs. 300.**
6. **Dividend on shares collected by the bank Rs. 300 credited in the Pass Book.**
7. **In March, the trader had got a bill discounted by his bank for Rs. 990 and entered the amount in the Cash Book as Rs. 1000 but the proceeds credited in the Pass Book were Rs. 990:**

Req: **(1) What will be the revised balance of Cash Book (after making necessary adjustments).**

(2) Prepare a Bank Reconciliation Statement as on 31.3.1990.

Solution:

REVISED CASH BOOK

(Bank Column Only)

Date	Particulars	Bank Rs.	Date	Particulars	Bank Rs.
1990			1990		
March 31	Interest on Investment	300	March 31	Balance o/d b/d	15000
March 31	Dividend on Shares	300	March 31	Interest on overdraft	200
			March 31	Insurance premium	1000
March 31	Balance o/d c/d	15610	March 31	Wrong debit to Cash	10
			March 31	Book now adjusted	
		16210			16210

NOTE:

The items, we have adjusted in the Revised Cash Book, now, will not be considered in the statement.

BANK RECONCILIATION STATEMENT

as on 31st March, 1990

	Rs.	Rs.
Revised overdraft balance as per Cash Book		Cr. 15610
Add: Cheque lodged into bank but not credited by the bank in Pass Book		Cr. 1400
		Cr. 17010
Less: Cheques issued but not presented at the bank till 31st March, 1990.		Dr 21000
Ans: Balance as per Pass Book (Cr.) or favorable.		Dr. 3990

PREPARING A BANK RECONCILIATION STATEMENT DIRECTLY FROM THE CASH BOOK AND THE PASS BOOK

Sometimes, the causes of discrepancy are not given to us, rather the Cash Book and the Pass Book are provided, and we have to find out the causes of disagreement our self to prepare a Bank Reconciliation Statement. This is done in the following way;

Debit and credit sides of pass book mean debit and Credit columns of Pass Book.

(1) When both the Cash Book and the Pass Book provided to us belong to the same period (same month), the causes are found out in this way i.e. items on the Debit side of the Cash Book (Bank Column) should be compared with those on the Credit side of the Pass Book and items on the Credit side of the Cash Book should be compared with those on the Debit side of the Pass Book. The items which are present in both the books are to be marked with tick (√). The items which do not agree (i.e. unticked items) will cause disagreement and these are to be considered in the statement.

ILLUSTRATION NO. 15

From the bank columns of Salman & Son's Cash Book and the relevant Pass Book, given below, search out the causes of disagreement between the two books and prepare a Bank Reconciliation Statement as on 31.07.1990.

Solution:

CASH BOOK (BANK COLUMN ONLY)

Date	Particulars	Bank Rs.	Date	Particulars	Bank Rs.
1990, July 1	Balance b/d	10,000√	1990, July 3	Dawood & Co.	2,500√
" 5	Bill Receivable discounted	11,900√	" 9	Naeem	1,000√
" 10	Rizwan & Co.	400√	" 16	Saleem Corp.	1,500√
" 20	Crown & Co.	1,800√	" 21	Asif	2,000
" 24	Rafiq & Sons.	4,000	" 27	Cash	1,200√
" 28	Cash	600√	" 30	Ahmad	5,500
" 31	Naseem & Co.	3,000	" 31	Balance c/d	18,000
		31,700			31,700

PASS BOOK (SALMAN & SONS A/C)

Date	Particulars	Withdrawals Dr.	Deposits Cr.	Dr/Cr	Balance
1990					
July 1	Balance b/d		10,000√	Cr	10,000
" 4	Dawood & Co.	2,500√		Cr	7,500
" 5	Bill discounted		11,900√	Cr	19,400
" 12	Rizwan & Co.		400√	Cr	19,800
" 13	Naeem	1,000√		Cr	18,800
" 17	Saleem Corp.	1,500√		Cr	17,300
" 27	Self	1,200√		Cr	16,100
" 28	Cash		600√	Cr	16,700
" 29	B/R Dishonored	12,000		Cr	4,700
" 30	Rehman & Sons		1,100	Cr	5,800
" 30	Interest on NIT units		300	Cr	6,100
" 31	Crown & Co.		1,800√	Cr	7,900
" 31	Bank Charges	100		Cr	7,800

The Cash Book is showing a Bank balance of Rs. 18,000 and the Pass Book is showing Rs. 7,800. The comparison of two books reveals the following causes of disagreement;

UNTICKED ITEMS

1. **Debit Side of the Cash Book:** Two cheques for Rs. 4,000 and Rs. 3,000 received from Rafiq & Sons and Naseem & Co. have not been collected, so not recorded in the Pass Book.
2. **Credit Side of the Cash Book:** Two cheques for Rs. 2,000 and Rs. 5,500 issued to Asif and Ahmad respectively have not been presented by them at the bank.
3. **Debit Column of the Pass Book:** A dishonored bill receivable for Rs. 12,000 and Bank Charges of Rs. 100 have not been recorded in the Cash Book.
4. **Credit Column of the Pass Book:** Amount directly deposited by Rehman & Sons (debtor) Rs. 1,100 and interest on NIT units have not been recorded in the Cash Book, although, credited in Pass Book.

SALMAN & CO.
BANK RECONCILIATION STATEMENT AS ON 31.07.1990

Starting from Cash Book balance

		Rs.	Rs.
	Balance as per Cash Book (Dr).		Dr. 18,000
Add. 1.	Cheques issued but not presented at the bank. (2,000 + 5,500)........................	7,500	
2.	Direct deposit into bank by Rehman & Co., not recorded in Cash Book............	1,100	
3.	Interest credited in Pass Book only.	300	Dr. 8,900
			Dr. 26,900
Less. 1.	Cheques deposited but not collected prior to 31st July. (4,000 + 3,000)...............	7,000	
2.	B/R discounted previously returned dishonored not entered in Cash Book....	12,000	
3.	Bank charges debited in Pass Book but not recorded in Cash Book..................	100	Cr. 19,100
Ans.	Balance as per Pass Book (Cr.)		Dr. 7,800

2. When the Cash Book and the Pass Book belong to different periods i.e. the Cash Book relates to March, while the Pass Book relates to April. In such a condition, the two books are compared in the same fashion as stated earlier and the items which agree are marked with tick (√). But in this case, the ticked items will cause disagreement. In other words, here, the ticked items have the same meaning as unticked items stated above. From these ticked items (which cause discrepancy), a Bank Reconciliation Statement will be prepared in the usual way :

PREPARING BANK RECONCILIATION STATEMENT BY TAKING BALANCES FROM BOTH THE RECORDS:

Traders record i.e. cash book balance (bank column) may be reconciled to banker's record i.e. bank statement balance or bank statement balance may be reconciled to the cash book balance. However, it is best to reconcile both the cash book balance and the bank statement balance to the correct cash at bank balance at the date of reconciliation with a statement called **"Double Balances Bank Reconciliation Statement".** Bank reconciliation statement is prepared in the following way when both balances are given:

CASH BOOK	
Balance as per Cash Book	×××
Add: Unrecorded Receipts: (credits given by bank but not recorded in Cash Book. e.g.	
– Dividend, Interest etc. collected by bank	
– Amount received by bank from customers on Trader's behalf).	×××
Less: Unrecorded Payments:	
(Debits given by bank but not recorded in cash book. For example, Bank charges, collection charges or payment made by bank on Trader's behalf).	×××
Less: Returned Cheques: (cheques sent to bank for collection but returned dishonored)	××
Cash Book Errors:	
Add: Amount wrongly credited in cash book	××
Less: Amount wrongly debited in cash book	××
Correct Bank Balance	×××

If Cash Book Balance is overdraft then the items added should be deducted and the items deducted should be added to bring **Correct Bank Balance.**

Bank Statement	
Balance as per Bank Statement	×××
Add: Outstanding Deposits: (cheques sent to bank for collection but not yet collected)	×××
Less: Outstanding cheques: (Cheques issued but not yet presented for payment)	×××
Banker Errors:	
Add: Amount wrongly debited by bank in Trader's Account.	××
Less: Amount wrongly credited by bank in Trader's Account	××
Correct Bank Balance	×××

If Bank Statement Balance is overdraft then the items added are deducted and vice versa in order to bring **Correct Bank Balance.**

ILLUSTRATION NO. 16

On 31st December, 1991, the bank statement showed a balance of Rs. 10,000 and as per cash book is Rs.8175.

1. **Cheques for of Rs. 2000 were paid in December, 1991, but out of these Rs. 900 were credited by the bank on December 20 and Rs. 700 on December 28 and the balance on January 2, 1992.**
2. **Cheques for Rs. 3,000 were issued to creditors of which those for Rs. 1800 were presented after 31st December, 1991.**
3. **A cheque for Rs. 100 although received and entered in the Cash Book but has been omitted to be banked.**
4. **An entry of Rs. 500 being payment by a customer direct into the bank appeared in the Pass Book.**
5. **In the Pass Book there was a credit of Rs. 35 for interest and a debit of Rs. 10 for the bank charges.**

Prepare a Bank Reconciliation Statement on 31st December, 1991 under double balance method.

Solution:

Bank Reconciliation Statement
As on 31st December, 1991

S. No.	DETAILS	Dr./Cr.	Cash Book	Dr./Cr.	Bank Statement
			Rs.		Rs.
	Balances	Dr.	8,175	Cr.	10,000
1.	Cheques deposited but not yet collected			Cr.	400
2.	Cheques issued but not yet presented for payment			Dr.	1800
3.	Cheque entered in Cash Book but omitted to be banked			Cr.	100
4.	Paid into bank directly by customer	Dr.	500		
5.	Interest credited in Pass Book only	Dr.	35		
5.	Bank charges debited in Pass Book only	Cr.	10		
	Correct Bank Balance	Dr.	8,700	Cr.	8,700

4. PETTY CASH BOOK

It is another Cash Book which is maintained, generally, in large business concerns to reduce the burden of 'Main Cash Book', in which numerous transactions involving petty (small) amounts are recorded. For this purpose, a Petty Cashier is appointed by the Chief Cashier. The Chief Cashier advances a sum of money to the Petty Cashier to enable him to meet petty expenses for a fixed period. The Petty Cashier will record this amount on the Debit Side of the Petty Cash Book while the Chief Cashier will record the same amount on the Credit Side of the Main Cash Book (we have already discussed).

The fundamental difference between the Main Cash Book and the Petty Cash Book is that only petty expenses are recorded in the Petty Cash Book. No receipt (with the exception of money received from the Chief Cashier), however small it may be, is recorded in it. But in the main Cash Book all receipts (big and small) and large expenses are recorded.

Thus we see that in large organisations both the books are essential, although the importance of the Petty Cash Book is somewhat less than the Main Cash Book.

Thus, the book in which small payments, which are not convenient to record in the Main Cash Book, (like postage, traveling expenses, purchase of stationery etc.) are recorded is called **Petty Cash Book.**

SYSTEMS OF PETTY CASH ACCOUNTING :

1. OPEN SYSTEM :

Under this system the Petty Cashier at first receives from the Chief Cashier a fixed sum of money for meeting petty expenses. As soon as the said amount is spent, the Chief Cashier again pays the required sum to the Petty Cashier.

2. FIXED ADVANCE SYSTEM :

Under this system the Petty Cashier receives from the Chief Cashier a fixed sum of money for a fixed period of time i.e. Rs. 200 per month. The Chief Cashier will pay Rs. 200 to the Petty Cashier every month irrespective of this that whether the Petty Cashier has spent the total sum or not.

3. IMPREST SYSTEM :

This system is generally followed by most of the business concerns. Under this system, the total petty expenses for a particular period are estimated and that amount is advanced by the Chief Cashier to the Petty Cashier. This amount is called Imprest Cash. On the expiry of the fixed period the Petty Cashier prepares a statement of his expenses and submits it to the Chief Cashier. This statement is known as Statement of Petty Expenses. The Chief Cashier examines the statement and if he finds it correct, hands over the Petty Cashier an amount equal to the amount actually spent. This amount plus the amount lying unspent with the Petty Cashier will be equal to the Imprest Cash.

In this way the Petty Cashier will start every time with an amount equal to Imprest Cash. In other words, the amount lying with the Petty Cashier will never exceed Imprest Cash. Generally a columnar Petty Cash Book is used in which different columns are provided for different petty expenses.

It is needless to mention that the balance of the Petty Cash Book will be shown on the asset side of balance sheet as "Cash in hand" at the end of the year.

ILLUSTRATION NO. 17

From the following particulars prepare a Petty Cash Book under Imprest System.

1991

Jan. 1.		**Received from the Chief Cashier as imprest cash Rs. 200.**
"	**2.**	**Paid Taxi hire Rs. 10.**
"	**3.**	**Paid postage Rs. 14 and stationery Rs. 30.**
"	**4.**	**Purchased stationery Rs. 24.**
"	**5.**	**Paid telegram charges Rs. 14 and bus fare Rs. 2.**
"	**6.**	**Bought postage stamps Rs. 48.**
"	**7.**	**Paid Rs. 36 for repairs of typewriter.**

Solution:

Petty Cash Book

Amount Received Rs.	Date	Particulars	V. No.	Total Rs.	Travelling Expenses Rs.	Postages Rs.	Stationery Rs.	Office Expenses Rs.	Miscellaneous Expenses Rs.
200	1991, Jun 1	Cash received							
	" 2	Taxi hire A/c		10	10				
	" 3	Postage A/c		14		14			
	" 3	Stationery A/c		30			30		
	" 4	Stationery A/c		24			24		
	" 5	Telegram A/c		14		14			
	" 5	Bus fare A/c		2	2				
	" 6	Postage A/c		48		48			
	" 7	Repairs A/c		36				36	
				178	12	76	54	36	
		Balance c/d		22					
200				200					
22	" 8	Balance b/d							
178		Cash received							

TEST YOUR KNOWLEDGE

1. Whether the following statements are true or false :
   (a) Discount columns of the Cash Book represent Discount A/c in the Ledger.
   (b) Bank columns of the Cash Book represent Bank A/c in the Ledger.
   (c) Cash columns of the Cash Book represent Cash A/c in the Ledger.
   (d). Bank columns of the Cash Book always show debit balance.
   (e) Discount columns of the Cash Book always show credit balance.
   (f) Contra entries appear on both sides of the Cash Book.

Ans: *[True : b, c, f. False : a, d, e.]*

2. The following are some of the causes of difference between the Cash Book and the Pass Book balances. If you start with the Cash Book balance (Dr.) in the Bank Reconciliation Statement, will you add them or deduct?
   (a) Cheque issued but not paid by the bank.
   (b) Cheque deposited but not credited by the bank.
   (c) Amount directly deposited by a customer into the bank but not recorded in the Cash Book.
   (d) Dividend collected by the bank but not entered in the Cash Book.
   (e) Insurance premium paid by the bank but not recorded in the Cash Book.
   (f) Interest on deposits credited by the bank but not recorded in the Cash Book.
   (g) Bank charges debited by the bank but not recorded in the Cash Book.
   (h) Cheque deposited and returned dishonored by the bank but no entry for dishonor was passed in the Cash Book.
   (i) Cheque issued but returned dishonored by the creditor, not recorded in the Cash Book.
   (j) Cheque deposited but no entry was passed in the Cash Book.
   (k) Cheque debited in the Cash Book but omitted to be banked.
   (l) Cheque deposited but wrongly entered in the Cash Column of the Cash Book.
   (m) Cheque deposited but wrongly entered on the credit side of the Cash Book.
   (n) Cheque deposited but the bank wrongly recorded on the debit side of the Pass Book.
   (o) Cheque issued but no entry was made in the Cash Book.
   (p) Cheque issued but wrongly recorded in the Cash Column of the Cash Book.
   (q) Cheque issued but wrongly debited in the Cash Book.
   (r) Cheque issued but the bank recorded it wrongly on the credit side of the Cash Book.
   (s) Credit side of the Cash Book was under cast.
   (t) Debit side of the Cash Book was overcast.
   (u) Cheque deposited into the bank but recorded twice in the Cash Book.
   (v) Cheque issued but recorded twice in the Cash Book.
   (w) Cheque deposited but entered twice in the Pass Book.
   (x) Cheque issued but entered twice in the Pass Book.

Ans: *[Add : a, c, d, i, j, l, m, r, v, w.*
Deduct : b, e, f, g, h, k, n, o, p, q, s, t, u, x.]

QUESTIONS

1. What is a Cash Book? What are its advantages?
2. What is a Cash Account? How does it differ from a Cash Book?
3. What is a Double Column Cash Book? Enter five imaginary transactions in a Double Column Cash Book.
4. What is a Contra Entry? How is it distinguished from other entries in the Cash Book.
5. What is a Treble Column Cash Book? What are its advantages.
6. What is a Petty Cash Book? How is it related to the Main Cash Book? Is it essential to maintain a "Petty Cash Book"? Give reasons for your answer.
7. What is a Bank Reconciliation Statement? Why and how it is prepared?
8. What are the causes of disagreement between a Bank balance as per the Cash Book and as per the Pass Book?
9. What is a Pass Book? How does it differ from a Cash Book.

PROBLEMS

			Rs.
1.	**(a)**	**Imran started business with cash.**	**50,000**
	(b)	**Bought goods from Asif and cash paid.**	**10,000**
	(c)	**Purchased a typewriter for the business.**	**2,000**
	(d)	**Paid carriage on goods bought.**	**600**
	(e)	**Paid octroi on goods.**	**400**
	(f)	**Sold goods to Waseem for Rs. 6,200 at 5% trade discount and cash received.**	
	(g)	**Paid insurance premium**	**250**
	(h)	**Paid Rs. 2,000 to Saleem as advance against our order for goods worth Rs. 10,000.**	
	(i)	**Paid office rent.**	**500**
	(j)	**Paid Saleem Rs. 4,000 on account.**	
	(k)	**Paid for salaries and wages.**	**2,500**
	(l)	**Paid Rs. 1,000 to traveling salesman Moeen for his traveling expenses.**	
	(m)	**Paid Rs. 3,000 to Mushtaq for sundry expenses.**	
	(n)	**Purchased office furniture of Rs. 2,000 from Sarfraz and paid him cash.**	
	(o)	**Cash sales Rs. 5,000.**	
	(p)	**Selling expenses paid Rs. 500.**	
	(q)	**Purchased stationery for Rs. 1,200 and cash paid.**	
	(r)	**Purchased one office almirah of Rs. 4,500 for cash.**	
	Req :	**Enter the above transactions in a Single Column Cash Book of Imran.**	

Ans : *[Cash Balance Rs. 26,440.]*

2. Enter the following transactions in a Double Column Cash Book (with Cash and Bank Columns) and in a Pass Book of Khan & Co. and find out the balance on 7.1.1991.

1991			Rs.
Jan.	1.	Cash in hand	50,000
"	"	Cash at bank	7,00,000
"	2.	Paid salaries	40,000
"	"	Paid rent by cheque	30,000
"	4.	Bought goods by cheque	4,30,000
"	5.	Sold goods for cash	75,000
"	6.	Bought machinery by cheque	1,25,000
"	"	Deposited into bank	70,000
"	7.	Withdrawn from bank for business use	45,000
"	"	Cash sales	90,000
"	"	Withdrawn cash from business for personal use	40,000
"	"	Received bank interest	3000

Ans: *[Cash balance Rs. 1,10,000; Bank balance Rs. 1,43,000.]*

3. Record the following transactions into the Cash Book (Double Column) of Afzal Corp. and find out the balances at the end of the month.

1990			Rs.
Sep	1.	Cash Balance	67,700
"	2.	Opened a current A/c with HBL and deposited cash therein	50,000
"	5.	Purchased furniture and paid by cheque	4,500
"	6.	Cash Sales	1,000
"	10.	Received from Sohail cash Rs. 500 and a cheque Rs. 3,000 and deposited the cheque into bank	
"	12.	Paid to Nisar by cheque	2,600
"	15.	Purchased goods and paid by cheque	5,800
"	16.	Withdrawn from bank by the owner for his own use	1,500
"	20.	Received cash as commission	600
"	23.	Received cash in full settlement from Khalid and sent the same into bank	500
"	29.	Withdrawn from bank for office use	5,000
"	30.	Paid salary	7,500
"	30.	Paid rent	400

Ans: *[Cash balance Rs. 16,900; Bank balance Rs. 34,100.]*

4. From the under mentioned information write up a Double Column Cash Book and strike out the balance at the end of the month.

1990			Rs.
May	1.	Cash in hand	30,000
"	1.	Cash at Bank	40,000
"	2.	Purchased furniture and paid by cheque	7,000
"	5.	Received two cheques; (a) from A, Rs. 10,000 and (b) from B. Rs. 5,000	
"	8.	Endorsed A's cheque to R and B's cheque sent to the bank	
"	12.	Cash purchases Rs. 8,000 less 5% Trade discount	
"	17.	Purchased stationery and paid cash	500
"	20.	Cash sales Rs. 2,000 and banked the same	
"	22.	Withdrawn from the bank Rs. 8,000 and paid wages Rs. 3,000 and rent Rs. 5,000	
"	23.	Received from X cash Rs. 3,000 and cheque Rs. 5,000, both deposited into the bank	
"	25.	Received cheque for sale of old machinery and banked	8,000
"	28.	Paid to Y cash Rs. 2,000 and cheque Rs. 3,000	
"	30.	Bank charged for commission	500
"	31.	X's cheque returned dishonored	

Ans: *[Cash balance Rs. 19,900; Bank balance Rs. 39,500.]*

5. Enter the following transactions in the books of A. Rahim in a Double Column Cash Book and balance the same on 30th April, 1990.

1990

April 1.	Cash in hand Rs. 40,000 and Bank overdrawn balance Rs. 1,35,000.
" 4.	Received two cheques for cash sales; (a) From X. Rs. 60,000. (b) From Y. Rs. 80,000.
" 5.	Endorsed the first cheque to purchase furniture from A and the second cheque to B to settle his account.
" 10.	Sold goods to M for cash Rs. 100,000 and deposited the same into the bank.
" 12.	The cheque endorsed to B returned dishonored.
" 16.	Purchased stationery for Rs. 5,000 by cheque.
" 16.	Paid wages in cash Rs. 10,000.
" 18.	Received from P Rs. 80,000 on account.
" 22.	Q, a customer deposited into the bank Rs. 35,000.
" 25.	Paid cartage Rs. 2,000.
" 25.	Bought furniture for cash Rs. 60,000.
" 30.	Bank debited Rs. 1,500 for incidental charges.
" 30.	Deposited all cash over Rs.20,000 into the bank.

Ans: *[Cash balance Rs. 20,000; Bank balance Rs. 21,500.]*

6. SL From the following particulars prepare a Treble Column Cash Book.

1991

Dec. 1.	Cash in hand Rs. 1,500 and at bank Rs.70,000.
" 2.	Received from Rameez Rs. 9,900, Discount allowed Rs. 100.
" 3.	Deposited into the bank Rs. 5,000.
" 4.	Purchased goods for Rs. 25,000 and paid by cheque.
" 5.	Sold goods to Amir on credit Rs. 7,000.
" 7.	Received from Amir a cheque for Rs. 7,000.
" 8.	Sold goods for cash Rs. 7,000.
" 9.	Paid Saleem Rs. 9,800 by cheque, discount received Rs. 200.
" 10.	Paid salaries Rs. 1,000.
" 11.	Paid telephone charges Rs. 600.
" 13.	Purchased goods for cash Rs. 4,000.
" 17.	Paid cash to Javed Rs. 1,850, discount received Rs. 150.
" 19.	Withdrew from the bank for business use Rs. 10,000.
" 21.	Purchased goods for Rs. 7,000 and paid by cheque.
" 23.	Sold goods for Rs. 5,000 and received the amount in cash.
" 25.	Paid rent by cheque Rs. 700.
" 27.	Received from Asif Rs. 5,900, discount allowed Rs. 100.
" 29.	Deposited cash into the bank Rs. 3,000.
" 31.	Paid for stationery Rs. 150.

Ans: *[Cash balance Rs. 30,700; Bank balance Rs. 25,500; Discount received Rs. 350; Discount allowed Rs. 200]*

7. SL Prepare a Three Columnar Cash Book of Mr. Aqib from the following transactions for the month of March 1991.

(a) Cash and bank balances as on 1st March, 1991 were Rs. 50,000 and Rs. 1,20,000, respectively.

(b) Cash sales on 1st, 9th, 15th and 28th of March, 1991 were Rs. 20,000, Rs. 10,000, Rs. 5,000 and Rs. 12,000 respectively with a cash discount of 2% on each.

(c) Salaries for the month of February 1991, paid on 2nd March, 1991 were Rs. 20,000.

(d) Cash purchases of goods were made on 4th, 8th, 15th and 25th March, 1991 for Rs. 10,000, Rs. 15,000, Rs. 13,000 and Rs. 24,000 respectively, with a discount of 1% on each.

(e) Withdrew cash from the bank Rs. 40,000 on 2nd March 1991 and Rs. 30,000 on 15th March, 1991.

(f). Paid into the bank Rs. 6,000 on 8th March and Rs. 12,000 on 10th March, 1991.

Ans: *[Cash balance Rs. 66,680; Bank balance Rs. 68,000; Discount received Rs. 620; discount allowed Rs. 940.]*

8.54 Enter the following transactions in a Cash Book with discount, cash and bank columns.

1990

Jan. 1.	Waqar commences business with Rs.2,00,000 in cash.
" 2.	He pays Rs. 1,50,000 into the bank.
" 3.	He pays Waseem Rs. 5,000 by cheque.
" 4.	He receives a cheque for Rs. 10,000 from Ahsan which he pays into the Bank.
" 5.	He receives a cheque for Rs. 6,000 from Khalid.
" 7.	He deposits the cheque received from Khalid into the bank.
" 8.	He receives cash from Tanveer Rs.9,700, allows him discount Rs.300.
" 13.	He receives a cheque for Rs. 18,000 from Zaheer and allows him a discount of Rs. 500.
" 18.	He deposits Rs. 20,000 into the bank.
" 19.	He purchases goods for cash Rs. 3,000.
" 20.	He receives a cheque for Rs. 5,800 from Manzoor and allows him a discount of Rs. 200.
" 20.	He receives a cheque for Rs. 5,000 for sales.
" 21.	He deposits Rs. 3,000 into the bank.
" 22.	He draws a cheque for Rs. 5,000 for office use.
" 23.	He draws a cheque for Rs. 5,000 for personal use.
" 24.	He pays cash for stationery Rs. 500.
" 25.	He pays rent by cheque Rs. 1,500.
" 26.	He purchases goods for cash Rs. 4,000.
" 26.	He pays office salaries by cheque Rs. 8,000.
" 27.	He gives a cheque for Rs. 7,500 for office furniture.
" 28.	He receives from Umer Rs. 8,500 and allows a discount of Rs. 250.
" 29.	He pays into the bank, the cheque for Rs. 5,800 received from Manzoor.
" 30.	He pays Rs.6,400 by cheque to Ali and received a discount of Rs.100.
" 31.	He receives a cheque from Osman for commission and deposits the same into the bank Rs. 10,000.
" 31.	He receives a cheque for Rs. 6,500 from Karim.

Ans: *[Cash balance Rs. 72,200; Bank balance Rs.1,66,400; Discount received Rs. 100; Discount allowed Rs. 1,250]*

9. Prepare a Petty Cash Book on the Imprest System from the following transactions :

1990

Jan. 1.	Received Rs. 100 from the Chief Cashier for Petty Cash.
" 2.	Paid bus fare Rs. 2.
" 2.	Paid cartage Rs. 4.
" 3.	Paid for postage and telegrams Rs. 9.
" 3.	Paid wages to casual laborers Rs. 10.
" 4.	Paid for stationery Rs. 8.
" 4.	Paid bus fare Rs. 5.

" 5. Paid for repair of chairs Rs. 20.

" 6. Paid Tonga charges Rs. 2.

" 7. Paid cartage Rs. 7.

" 7. Paid for postage and telegrams Rs. 12.

" 7. Paid cartage Rs. 10.

" 8. Paid for stationery Rs. 5.

BANK RECONCILIATION STATEMENT:

10. Prepare a Bank Reconciliation Statement as on 31st December, 1991 from the following particulars.

    (i) Bank balance as per the Cash Book on 31st Dec. 1991, Rs. 23,510.

    (ii) Cheques for Rs. 3,000 deposited for collection but not credited by the bank prior to 31st December, 1991.

    (iii) Cheques amounting to Rs. 4,000 were issued on 28th December, out of which cheques for Rs. 3,000 were cashed up to 31st December, 1991.

    (iv) A wrong debit of Rs. 400 appeared in Pass Book.

    (v) Bank charges Rs. 10 appeared in the Pass Book but not in the Cash Book.

    (vi) Interest on investment collected by the bank not yet recorded in the Cash Book Rs. 1,000.

Ans: *[Balance as per the Pass Book (Cr) Rs. 22,100.]*

11. From the following particulars ascertain the bank balance as per the Cash Book of Naveed & Co. as on 31st March, 1990.

    (a) Bank balance as per the Pass Book on 31st March, 1990 was Rs. 80,000.

    (b) Cheques issued in the last week of March, 1990 but not presented for payment till 31st March, 1990, amount to Rs. 12,000.

    (c) Cheques paid into Bank on 26th March, 1990, but not collected prior to 31st March, 1990 amount to Rs. 20,000.

    (d) Interest on deposits of Rs. 2,000 was credited in the Pass Book but not recorded in the Cash Book till 31st March, 1990.

    (e) A customer paid into the bank Rs. 15,000 directly as appeared in the Pass Book but not in the Cash Book.

    (f) Dividend money of Rs. 8,000 on the shares held by Naveed & Co. was received directly by the bank on 29th March, 1990, but the intimation was sent to them on 2nd April, 1990.

Ans: *[Bank balance as per the Cash Book (Dr) Rs.63,000]*

12. On 30th June, 1990, the Cash Book of Mr. Zubair showed an overdraft balance of Rs. 16,000. This balance did not agree with the balance as per the Pass Book. On comparing the two books, the following discrepancies were noted;

    1. Cheques for Rs. 4,000 paid into the bank for collection on 28th June, 1990 have not yet been collected.

    2. Cheques for Rs. 3,000 issued on 26th June, 1990 have not yet been presented for payment.

    3. An amount of Rs. 600 for interest on overdraft was debited in the Pass Book but was intimated to Mr. Zubair on 2nd July, 1990.

4. Collection charges of Rs. 14 were entered in the Pass Book but not in the Cash Book.
5. Mr. Zubair paid into his bank account in cash an amount of Rs. 2,000 but it was wrongly credited to Mr. Yousaf's account.
6. On 30th June, 1990, the bank received interest of Rs. 1,500 from a company on Mr. Zubair's deposits with that company : (You are required to find out the balance as per the Pass Book.)

Ans: *[Bank overdraft as per the Pass Book Rs. 18,114]*

13. The Bank Statement Account No. 16 of Mr. Saleem showed an overdraft of Rs. 67,150 on 31st December, 1989. On going through the Pass Book and the Cash Book, the accountant found the following;

1. A cheque for Rs. 2,160 wrongly credited in the Bank Statement on 28th December, 1989, and being dishonored again debited in the Bank Statement on 1st January, 1990. There was no entry in the Cash Book about the dishonor of the cheque until 15 Jan. 1990.
2. Interest collected and credited by the bank in the Bank Statement on Mr. Saleem's behalf but the same had not been recorded in his Cash Book Rs. 5,600.
3. Cheques of Rs. 41,000 paid into the bank for collection on 30th Dec. but cheques amounted to Rs. 15,000 were collected on 7th January, 1990.
4. Out of cheques amounting to Rs. 15,600 drawn by him on 27th December, a cheque for Rs. 5,000 was encashed on 3rd January, 1990.
5. The banker has given him a wrong credit for Rs. 1,000 paid in by him in another account (A/c No. 17) and a wrong debit in respect of a cheque for Rs. 600 drawn on Account No. 17.

Req : Prepare a Bank Reconciliation Statement as on 31st December, 1989.

NOTE:

The cheque for Rs. 2,160 debited in the Cash Book and credited in the Pass Book before 31st December itself. Therefore, no difference will arise in the balances on 31.12.1989. This cheque was dishonored on 1st January, so this should not be considered in the statement.

Ans: *[Balance as per the Cash Book (Cr.) Rs. 63,150.]*

14. Prepare a Bank Reconciliation Statement from the following particulars :

1. Overdraft balance as per the Pass Book (Dr.) on 31.12.1990, Rs. 5,000.
2. Bank charges for collecting an out station cheque Rs. 7.50 appeared only in the Pass Book.
3. Interest on overdraft charged by the bank for half year, Rs. 275, debited in the Pass Book only.
4. Two cheques for Rs. 7,500 and Rs. 5,000 paid in on 30th December, 1990, were not credited by the bank.
5. Two cheques for Rs. 1,050 and Rs. 4,000 issued in December 1990 had not been presented at the bank during the month.

Ans: *[Balance as per the Cash Book (Dr.) Rs. 2,732.50]*

15. On 31st March, 1992, the Bank Balance of Mr. Safdar Khan appeared at Rs. 3,400 in his Cash Book. On reconciling with the Pass Book the following information was ascertained. You are required to show the balance as per the Pass Book on 31.03.1992.

1. Debit in respect of the bank charges Rs. 32, credit in respect of the bank interest Rs. 140 and dividend received by the bank as Rs. 900 were not passed in the Cash Book.
2. A Bill Receivable for Rs. 700 was realized by the bank, but no entry was passed in the Cash Book.
3. Cheques for Rs. 700 were issued but not yet presented for payment.
4. Cheques for Rs. 800 were paid into the bank, but not collected and credited by the bank.
5. A cheque for Rs. 10 was shown in the Pass Book as dishonored.

Ans: *[Balance as per the Pass Book (Cr.) Rs. 4,998]*

16. A trader prepares at the end of each month, a Bank Reconciliation Statement for his business. Draft one such statement from under mentioned items as on 31.12.1988.

1. Cash and cheques totaling Rs. 73,900 were sent to the bank in the month of December, but out of them one cheque for Rs. 9,000 was credited in the Pass Book on 2nd January, 1989.
2. On 26th December cheques were issued in favor of Creditors for Rs. 19,000, but out of them two cheques for Rs. 14,000 were encashed on 3rd January, 1989.
3. One customer had deposited directly into the bank Rs. 2,500 but it was not mentioned in the Cash Book.
4. The trader had withdrawn from the bank Rs. 7,000 but the same had not been entered in the Cash Book.
5. On 29th December, a cheque for Rs. 6,000 was received and entered in the Cash Book but had been omitted to be sent to the bank.
6. On 27th December, 1988 Rs. 350 were credited in the Pass Book as interest on deposits but the same had been recorded in the Cash Book on 31st December, 1988.
7. Bank balance as per the Cash Book Rs. 40,000.

Ans: *[Balance as per the Pass Book (Cr.) Rs. 34,500]*

17. From the following particulars of Mr. Nasir Ali, prepare a Bank Reconciliation Statement as on 31st December, 1990.

(i) A cheque of Rs. 400, which was received from a customer, was entered in the bank column of the Cash Book in December, but was paid into the bank in January next.

(ii) The trader has issued cheques in December for Rs. 32,000 of which he finds that a cheque for Rs. 14,000 was cashed in December, a cheque for Rs. 7,000 was cashed on 2nd January and the others were not presented at all.

(iii) The banker gave a wrong credit in Account No. 1 in respect of a cheque for Rs. 9,000 which was deposited in Account No. 2.

(iv) As per the standing orders, the following payments were made by the bank out of Account No. 2;

(a) Insurance premium Rs. 260.

(b) Calls on shares Rs. 1,080.

(v) The bank has received the following amounts for Account No. 2;

(a) Dividend on share Rs. 640.

(b) Insurance claim Rs. 1,700.

(vi) Bank charges Rs. 50 were not recorded in the Cash Book.

(vii) Overdraft balance as per the Cash Book, Bank Account No. 2 was Rs. 19,600 on 31st December.

Ans: *[Balance overdrawn as per the Pass Book Rs. 10,050]*

18. A trader has two Bank Accounts — A/c No. 1 and A/c No. 2. The following particulars relating to A/c No. 1 are available on 31st March, 1990 :

1. Pass Book balance (overdrawn) Rs. 30,000.
2. Cheques drawn prior to 31st March but not presented as yet Rs. 8,000.
3. Cheques paid into the bank on 31st March, 1990 but not yet credited Rs. 14,000.
4. Interest debited by the bank but not entered in the Cash Book as yet Rs. 800.
5. Transfer from A/c No. 2 to A/c No. 1 recorded by the bank on 31st March, but not entered in the Cash Book Rs. 6,000.
6. Bank charges debited by the bank but not recorded in the Cash Book as yet Rs. 20.

Ans: *[Balance as per the Cash Book (Cr.) Rs. 29,180]*

19. On 31st March, 1989, the Cash Book of Mr. Nadeem shows Rs. 16,728 as bank balance. But it does not agree with the balance as shown by the Pass Book. On comparison, you find the following discrepancies.

1. The payment side of the Cash Book was under cast by Rs. 200.
2. A cheque issued for Rs. 262 on 25th March, was recorded in the Cash Column.
3. A cheque of Rs. 300 deposited was recorded in the Cash Column of the Cash Book.
4. On 20th March, the debit balance of Rs. 3,052 as on the previous day was brought forward as credit balance.
5. Of the total cheques amounting to Rs. 23,028 drawn in the last week of March, 1989, cheques totaling Rs. 15,630 encashed in March.
6. Dividends of Rs. 500 collected by the bank were not entered in the Cash Book.
7. Trade subscription of Rs. 200 paid by the bank was not recorded in the Cash Book.
8. One outgoing cheque for Rs. 700 was recorded twice in the Cash Book.

Req : Prepare a Bank Reconciliation Statement as at 31st March, 1989.

Ans: *[Balance as per the Pass Book (Cr.) Rs. 31,068]*

20. From the following particulars, prepare a revised Cash Book and a Bank Reconciliation Statement of Punjab Stores as on 28th February, 1988.

(a) Credit balance as per the Cash Book on 28.02.1988 was Rs. 30,000.

(b) A wrong debit of Rs. 1,000 has been given by the bank in the Pass Book.

(c) Bank charges made by the bank Rs. 240 were recorded only in the Pass Book.

(d) Out of the cheques for Rs. 50,000 paid into the bank, cheques for Rs. 37,500 were cleared and credited by the bank.

(e) Two cheques for Rs. 15,000 and Rs. 30,000 were issued but out of them only one cheque for Rs. 15,000 was presented for payment up to 28th Feb., 1988.

(f) Dividend on shares Rs. 9,000 was collected directly by the bank. The trader has no information about this.

(g) The Pass Book contains an entry for Rs. 10,000 being a direct payment made by a customer into the bank.

Ans: [*Revised Cash Book balance (Cr.) Rs. 11240.*
Balance as per Pass Book (Cr. or favourable) Rs. 5260]

21. From the following particulars, prepare a Bank Reconciliation Statement of Mr. Qasim as on 31st March, 1990 with the help of a revised Cash Book.

(a) Bank overdraft as per the Cash Book Rs. 12,000.

(b) Rs. 40,000 worth of cheques were sent for collection and only Rs. 25,000 worth of cheques were collected up to 31st March.

(c) Out of cheques for Rs. 30,000 issued in March, cheques of Rs. 18,000 were presented for payment.

(d) Bills discounted with the bank and dishonored Rs. 30,000.

(e) A customer directly deposited an amount of Rs. 28,000 into the bank.

(f) Interest on overdraft Rs. 1,250 debited in the Pass Book only.

(g) A cheque for Rs. 5,000 entered in the Cash Book (Debit Side), was not sent to the bank for collection.

(h) Discount received Rs. 250 was entered in the Bank Column erroneously.

Ans: [*(a) Revised Cash Book balance (Cr.) Rs. 15000.*
(b) Balance as per the Pass Book overdrawn Rs. 23000]

22. The Cash Book of a trader (only Bank Column) is given below for the month of July, 1990.

	Rs.		Rs.
Balance b/d	28,140	Payments	3,10,400
Receipts	3,01,460	Balance c/d	19,200
	3,29,600		3,29,600

On comparing, the Cash Book with the Bank Statement (Pass Book), the following discrepancies were noted.

1. Bank charges of Rs. 700 shown on the bank statement have not been recorded in the Cash Book.
2. A cheque drawn for Rs. 940 has been recorded as a receipt.
3. A cheque for Rs. 360 has been returned dishonored by the bank but not written back in the Cash Book.
4. The opening balance of the Cash Book should have been brought down as Rs. 29,400 instead of Rs. 28,140.
5. Three cheques issued to the suppliers for Rs. 4,280, Rs. 7,400 and Rs. 600 have not yet been presented to the bank.
6. A pay-in-slip of the month of July, showing a deposit of Rs. 30,840 has not yet been credited by the bank.
7. The bank has wrongly debited a cheque for Rs. 1,440 to the trader's account.

Req: 1. Revise the Cash Book for the month, July, 1990.
2. Prepare a Bank Reconciliation Statement as on 31.07.1990.

Ans: [*1. Revised Cash Book Balance (Dr.) Rs. 17520.*
2. Balance as per the Pass Book overdraft (Dr.) Rs. 2480]

23. Prepare a Bank Reconciliation Statement under double balance method from the following particulars as on 30.6.2000.

1. Bank balance as per the Bank Statement (Dr.) Rs. 3,000.
2. Overdraft as per Cash Book Rs.3700.
3. Cheques deposited into the bank but not yet collected Rs. 970.
4. Cheques drawn but not yet presented to the banker Rs. 1,600.
5. The banker charged Rs. 30 for commission.
6. Dividend collected by bank Rs. 100.

Ans: *[Correct Bank Balance Rs.3630]*

24. On 31st July, 1999, a trader has an overdraft of Rs. 10,000 as shown by the bank column of his Cash Book and overdraft as per bank statement is Rs.4920. It is, however, discovered that cheques for Rs. 1,000 deposited into the bank remained uncredited in the Pass Book up to this date. So another cheque for
Rs. 2,700 is as yet unpaid. Further the Pass Book is debited with Rs. 20 for the bank charges, Rs. 100 for interest on overdraft and Rs. 500 for insurance premium as per trader's instructions, and credited with Rs. 4,000 directly deposited by a customer of the trader. But none of these items as yet appears in the Cash Book.

Req : Prepare a Bank Reconciliation Statement with double balance method.

Ans: *[Correct Bank Balance Rs. 6620]*

25. From the under mentioned particulars, prepare a Bank Reconciliation Statement under double balance method as on 31st March, 2000.

(a) Bank overdraft as per the Bank Statement Rs. 4,600.
(b) Overdraft as per cash book Rs.10600.
(c) Cheques for Rs. 10,400 were issued in March, out of which those for Rs. 4,000 only were presented up to 31st March.
(d) A cheque for Rs. 1,000 was deposited into the bank but was wrongly recorded on the credit side of the Cash Book.
(e) The credit side of the Cash Book was under cast by Rs. 1,600.
(f) A cheque for Rs. 800 was debited twice in the Cash Book.

Hints: For item No. (d) there will be a discrepancy of Rs. 2,000. (1,000 + 1,000).

Ans: *[Correct Bank Balance Rs. 11,000]*

26. Cash Book of Mehmood & Co. showed bank balance as Rs.50,000 and bank balance as per Pass Book (Bank Statement) was Rs.46000. The following were the discrepancies:

1. Cheques drawn for Rs.25000 in March, 2000 but cheques for Rs.10,000 were encashed in April, 2000.
2. Interest allowed by bank Rs.5000 was not entered in Cash Book.
3. Cheques totaling Rs.45000 were sent to bank for collection but out of them cheques for Rs.15000 were not collected by bank.
4. Bank charges debited in Pass Book Rs.1000.

5. Bill receivable discounted was dishonored for Rs.3000 but this was not written back in cash book.

Prepare: A bank Reconciliation statement as on 31st March 2000.

Ans: *[Correct Bank Balance Rs. 51,000]*

Q.27 Shown below is the information needed to prepare a bank reconciliation for Umer Center at December 31st 2000.

1. At December 31st, bank balance per bank statement was Rs. 37,758; per the accounting records Rs. 42,500.
2. The cash receipts of Rs. 6,244 on December 31st were deposited on January 1st.
3. Included on the bank statement was a credit for Rs. 167 interest earned on this account during December.
4. Two cheques were outstanding at December 31st.
   Cheque No. 921 for Rs. 964
   Cheque No. 925 for Rs. 1085
5. Enclosed with the bank statement was debit memoranda for service charges storing December Rs. 14.
6. Rs. 700 cheque of customer Usman Bros. market "NSF" (Not Sufficient Funds) by bank.

Req : (a) Prepare a bank reconciliation at December 31st.

(b) Prepare journal entries to adjust the accounts at December 31st. Assume that the accounts have not been closed.

(c) State the amount of bank balance which should be included in Balance Sheet of December 31st.

Ans: *[Correct Bank Balance Rs. 41953]*

28. Rectify the following Bank Reconciliation Statement if you find it incorrect :

Bank Reconciliation Statement as on 31.12.1990.

	Rs.	Rs.
Bank overdraft as per the Pass Book.....................		24,000
Add : 1. Cheques deposited but not collected..........	18,000	
2. Cheques issued but not yet paid..............	14,000	
3. Cheques deposited but dishonored not recorded in the Cash Book..............	4,000	
4. Cheques issued but reported lost by the payee (Creditors)........................	6,000	42,000
		66,000
Less : 1. Amount deposited directly into the bank by a customer not recorded in the Cash Book................	8,000	
2. Interest on overdraft not recorded in the Cash Book..............................	3,400	11,400
Balance as per the Cash Book (Cr.)		54,600

Ans: *[Correct balance as per the Cash Book (Cr.) 26,600]*

29. Prepare a Bank Reconciliation Statement from the entries in the Cash Book (bank column) and the Pass Book given below as on 31.12.1990.

CASH BOOK (BANK COLUMN ONLY)

Dr. **Cr.**

Date	Particulars	Bank Rs.	Date	Particulars	Bank Rs.
1990,			1990,		
Dec. 1	Balance b/d	1,40,000	Dec. 5	Salaries (Cheque No. 987)	16,000
" 4	Rehman (Cheque No. 237)	24,000	" 8	Drawings (Cheque No. 988)	28,000
" 9	Karim (Cheque No. 567)	30,000	" 10	Badar (Cheque No. 989)	18,000
" 17	Babar (Cheque No. 138)	12,000	" 14	Karim (Cheque No. 990)	26,000
" 24	Mahmood (Cheque No. 46)	16,000	" 19	Furniture (Cheque No. 991)	9,000
" 28	Yasar (Cheque No. 431)	8,000	" 22	Commission	1,000
" 31	Saleem (Cheque No. 239)	10,000	" 25	Salman (Cheque No. 992)	22,000
			" 28	Mohsin (Cheque No. 993)	20,000
			" 31	Balance c/d	1,00,000
		2,40,000			2,40,000

BANK PASS BOOK

Date	Particulars	Withdrawals Dr.	Deposits Cr.	Balance
1990		Rs.	Rs.	Rs.
Dec. 1	Balance b/d			1,40,000
" 5	Cheque No. 987 - Salaries	16,000		124000
" 6	Cheque No. 237 - Rehman		24,000	1,48,000
" 8	Cheque No. 988 - Drawings	28,000		1,20,000
" 12	Cheque No. 567 - Karim		30,000	1,50,000
" 13	Cheque No. 989 - Badar	18,000		1,32,000
" 15	Cheque No. 990 - Karim	26,000		10,6000
" 19	Cheque No. 991 - Furniture	9,000		97,000
" 20	Cheque No. 138 - Babar		12,000	1,09,000
" 22	Commission	1,000		1,08,000
" 26	Cheque-dividend		6,000	1,14,000
" 31	Bank Charges	400		1,13,600

CHAPTER - 9

JOURNAL PROPER AND SUMMARY OF BOOK KEEPING TO THE TRIAL BALANCE

JOURNAL PROPER AND SUMMARY OF BOOK KEEPING TO THE TRIAL BALANCE

The students are required to read this chapter thoroughly to have a clear understanding of Final Accounts.

We have already discussed, how most of the common transactions in business are originally recorded: the purchases, sales and return of goods, and the payment and receipt of cash. Now we turn to a consideration of some of the less common items which occur, not every day, but only a few times in a year. These items or transactions are usually recorded in the **"Journal Proper"**, a Day Book which has been in use since the Middle Ages.

As we know, in special journals, transactions of special nature are recorded, e.g. credit purchase of goods in Purchases Journal, credit sales of goods in Sales Journal, returns to the suppliers in Returns Outward Journal, returns from the customers in Returns Inward Journal etc. But there are some transactions which cannot be recorded in any special Journal. They are recorded in Journal Proper or General Journal. For example, Furniture is purchased from 'City Furniture Stores' for Rs. 10000 on credit. We cannot record this transaction in any special Journal, so it will be recorded in Proper Journal. I the same way, goods are taken away by the owner for his personal use worth Rs. 2000. This transaction cannot be recorded in any Special Journal, so it will also be recorded in Proper Journal.

Thus, the book of account where all the transactions for which there are no Special Journals, are primarily recorded is known as **"Journal Proper or General Journal"**.

The ruling of Journal Proper is a traditional ruling which is illustrated below;

PROPER JOURNAL OR GENERAL JOURNAL

Date	Description	L/F	Dr. Amount	Cr. Amount
	Account to be debited Account to be credited			

The transactions which are recorded in the Proper Journal may be divided into following groups;

1. Opening entries
2. Closing entries
3. Adjustment entries
4. Rectifying entries
5. Transfer entries
6. Rare transactions or Residuary entries

The above mentioned groups of entries are discussed in details below:

1. OPENING ENTRIES:

At the beginning of every year, new books of accounts are opened. The closing balances of all the accounts (Assets A/c, Liabilities A/c and capital A/c) will be the opening balances of the new year. Entries are necessary to bring these balances in the books of accounts of the new year. These entries are known as **opening entries**, and are passed in Proper Journal.

ILLUSTRATION NO. 1

The following are the ledger accounts balances of a trader on 31st March, 1990. Give the Journal entries to open the accounts in 1991:

	Rs.		Rs.
Cash in hand	**10,000**	**Creditors**	**24000**
Debtors	**20,000**	**Capital**	**146000**
Furniture	**40,000**		
Machinery	**100,000**		
	170,000		**170,000**

Solution:

Date	Description		L/F	Dr. Amount	Cr. Amount
1991					
April 1	Cash Account	Dr.		10,000	
	Debtors Account	Dr.		20,000	
	Furniture Account	Dr.		40,000	
	Machinery Account	Dr.		100,000	
	Creditor Account				24000
	Capital Account				146000
	(Being incorporation of opening Assets and liabilities)				

2. CLOSING ENTRIES:

At the end of every accounting period, all accounts relating to Expenses and Revenues are closed by transferring their balances to Trading and Profit and Loss Account. Entries are necessary for such transfer, which are known as **'Closing Entries'.**

ILLUSTRATION NO. 2

The following ledger balances are extracted on 31st December, 1990.

Salaries A/c	**Rs. 4000**	**Interest A/c (Cr.)**	**Rs. 1400**
Wages A/c	**Rs. 3000**		
Rent A/c	**Rs. 3200**		

Pass the Journal entries to close the accounts on 31st December, 1990.

Solution:

JOURNAL PROPER

			Dr. Rs.	Cr. Rs.
1990 Dec. 31	Trading Account Dr.		3000	
	Wages Account			3000
	Being the Transfer of wages to Trading A/c			
	Profit and Loss Account Dr.		7200	
	Salaries Account			4000
	Rent Account			3200
	Being the balances transferred to P & L A/c			
	Interest Account Dr.		1400	
	Profit and Loss Account			1400
	Being transfer of balance to P & L A/c			

3. ADJUSTMENT ENTRIES:

At the end of the accounting period, when Final Accounts are prepared, some items of Revenue and expenses require adjustments e.g. outstanding expenses, prepaid expenses, Accrued Revenue, depreciation etc. Entries are necessary to record these adjustments and are known as **'Adjustment Entries'**.

ILLUSTRATION NO. 3

Pass necessary entries for the following adjustments on 31st December, 1990.

1. **Salaries payable Rs. 8000.**
2. **Depreciation on Machinery Rs. 4000.**

Solution:

JOURNAL PROPER

			Dr. Rs.	Cr. Rs.
1990 Dec. 31	Salaries Account Dr.		8000	
	Salaries Payable Account			8000
	(Being Salaries payable adjusted)			
	Depreciation Account Dr.		4000	
	Machinery Account			4000
	(Being depreciation on Machinery charged)			

4. RECTIFYING ENTRIES:

If there is any error in the books of account, it must be rectified. But errors are not rectified by erasing the wrong figures. All errors are rectified by passing fresh Journal entries. These entries are known as **Rectification Entries.**

ILLUSTRATION NO. 4

Goods sold to Karim for Rs. 1000 on credit have been wrongly debited to Kalim A/c. Pass the rectifying entry.

Solution:

JOURNAL PROPER

			Dr. Rs.	Cr. Rs.
	Karim Account Dr.		1000	
	Kalim Account			1000
	(Being wrong debit to Kalim, now rectified)			

5. TRANSFER ENTRIES:

Any transfer of amounts from one account to another account is done through Journal Entry. Such entry is known as **'Transfer Entry'**.

ILLUSTRATION NO. 5

An amount of Rs. 3000 is transferred from the Debit side of Akram A/c to Rashid A/c. Give Journal entry for the transfer.

Solution:

JOURNAL PROPER

			Dr. Rs.	Cr. Rs.
	Rashid Account Dr. Akram Account (Being the transfer of amount from Akram A/c to Rashid A/c)		3000	3000

6. RARE TRANSACTIONS OR RESIDUARY ENTRIES:

All the remaining transactions except those mentioned above, which cannot be recorded in any special journal are known as **'Residuary Transactions'**, and are recorded in Journal Proper e.g. Credit Sale or purchase of assets, depreciation on assets, Goods given away as free samples etc.

ILLUSTRATION NO. 6

Pass the necessary journal entries to record the following residuary transactions,

1. **Purchased furniture from Kashif Bros. for Rs. 10,000 on credit.**
2. **Goods distributed as free samples worth Rs. 4000.**

Solution:

JOURNAL PROPER

			Dr. Rs.	Cr. Rs.
	Furniture Account Dr. Kashif Bros. Account (Being furniture purchased on credit)		10,000	10,000
	Free Sample Account Dr. Purchases Account (Being goods distributed as free samples)		4000	4000

A SUMMARY OF BOOK–KEEPING TO THE TRIAL BALANCE:

The book–keeping upto the Trial Balance involves the following five stages, (the summary of which is given below):

STAGE 1:

Transactions with Organic Documents:

Every business transaction that takes place, whether it is a purchase, a sale, a return, a payment, a receipt or some other type of transaction, has an 'Original document'. These documents are called Invoices, Credit Notes, Payment Voucher, Receipts or Petty Cash vouchers. Transactions are recorded on the basis of these documents.

STAGE 2:

The Books of Original Entry:

When we have a document we first record it in a Book of Original Entry. These books may be special Journals (subsidiary Books i.e. Purchases Book, Sales Book, Returns Inwards Book, Returns Outwards Book, Cash Book like the three column Cash Book or the Petty Cash Book) or Journal Proper. We may also have Bill Books (Bill Receivable Book and Bill Payable Book) to record Bills of Exchange. In these books, all business transactions are originally recorded with the help of original documents.

STAGE 3:

Posting the Books of Original Entry to the Ledger:

When we have recorded the transactions in special Journals and Journal Proper with the help of original documents, we then post the transactions into the Ledger, which is the main book of account. Every transaction will appear twice, because one account will be debited and another will be credited. Equal debit will be made in one account/accounts and equal credit entry in some other account/accounts. Hundreds, even thousand and one accounts may be involved, but if we do our double entry carefully the total entries on the debit side will exactly balance the total entries on the credit side. This is the way we check the books of accounts, by taking out a Trial Balance.

STAGE 4:

Taking out a Trial Balance:

This is what is name indicates, an attempt to discover whether the books of accounts really do balance. If they do not, we know that someone has made a mistake somewhere, and we must discover and rectify it.

We usually make a Trial Balance at least once a month, bringing all the debit balances into a list of debit balances, and all credit balances into a list of credit balances. These two columns of balances or lists of balances should come exactly equal, and we may conclude that we have done our book–keeping fairly well.

Book–keeping to the Trial Balance level is the first stage of accounting knowledge. The second and rather more difficult, stage of book–keeping is called 'Final Accounts Level'. This is explained in further three stages.

STAGE 5(a):

Final Accounts – The Trading Account:

We are know in a very good position to find out whether our business is profitable or running at a loss. For this purpose we prepare a simple Trading Account. The Trading Account shows whether we are selling our goods or services at profit. In this account, we make a comparison between our sales and purchases including other direct expenses. We take our sales figures from the Sales Account in the Trial Balance and our Purchases figures from our Purchase Account n the Trial Balance. After taking into consideration some other items like opening stock, closing stock and direct expenses (the expenses connected with purchases) we find out the cost of goods sold. Then sales minus cost of goods sold gives us overall profit – which is called in book–keeping the **"Gross Profit"**. Gross profit =sales – Cost of goods sold.

STAGE 5(b):

Final Accounts – The Profit and Loss Account:

In this second half of our Final Accounts we start with the Gross Profit, resulting from Trading Account, and deducts from it all overhead expenses (Indirect expenses). We add some items of revenue which are not part of the normal trading, such as commission received, interest received etc. to the Gross Profit. This gives us the clear profit or clean profit which is called in book–keeping **"Net Profit"**. This net profit is the reward of the businessman for his efforts, and is added to his Capital Account.

STAGE 5(c):

Final Accounts – The Balance Sheet:

We have discussed in Stage 5a and 5b that Trading Account and Profit and Loss Account are prepared by making a comparison between Revenues and expenses and the result it profit or loss. The profit is added to the owner's Capital Account (or perhaps loss which is deducted from owner's Capital Account). Now all we need to do is to summarize the final position of the business by drawing up a **"Balance Sheet"** which shows the assets and Liabilities of the business. Balance sheet is a statement having two sides, the Assets side and the Liabilities side. It is usually prepared on the last day of the accounting period and this is the stage where Accounting cycle comes to an end.

We have discussed the general pattern of double entry book–keeping up-to the completion of accounting cycle. For students understanding, all these stages are illustrated again a chart on page _______.

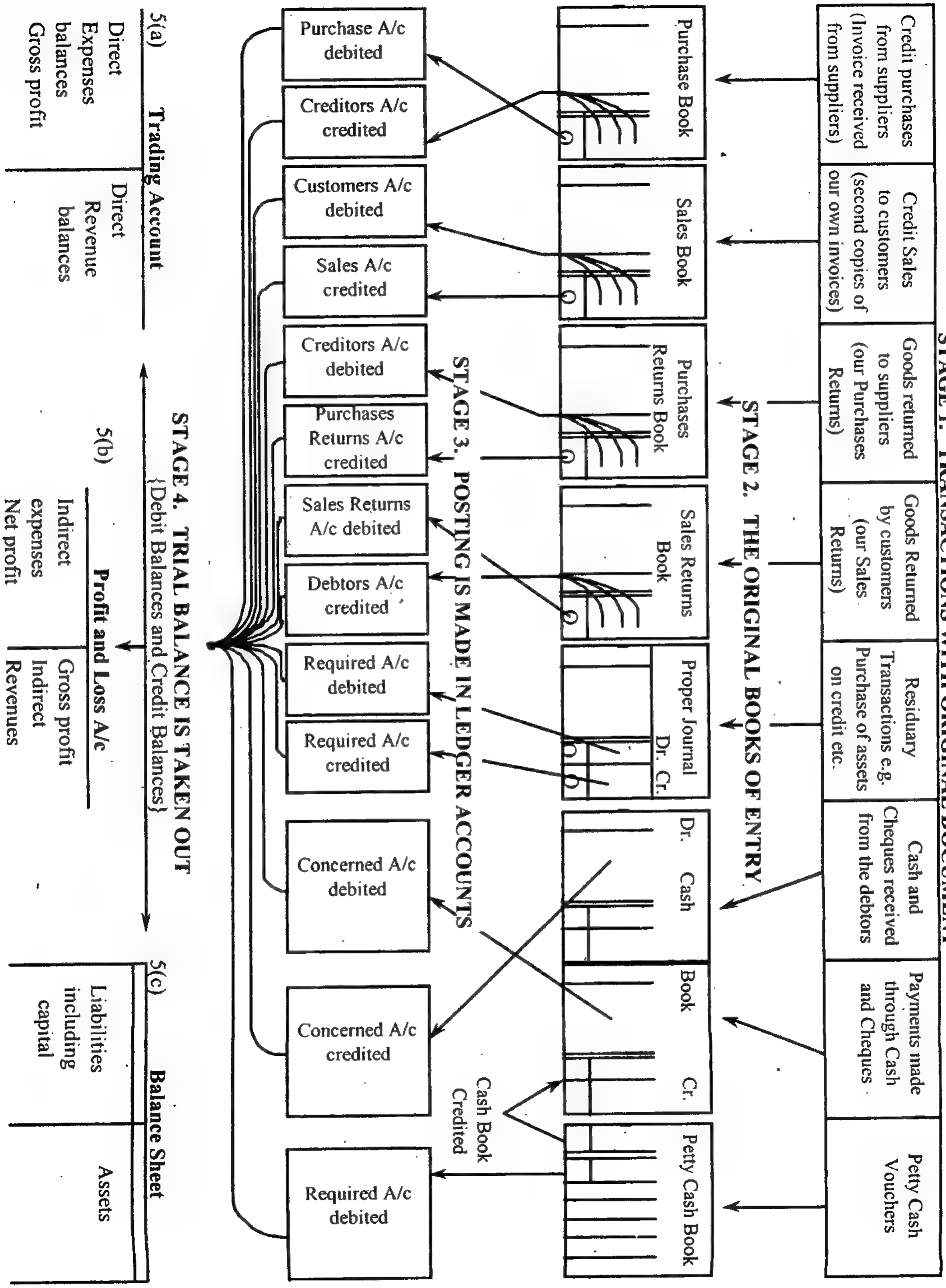
Now, an illustration is given below which will cover the book–keeping to the Trial Balance.

ILLUSTRATION NO. 7

Enter the following transactions in various subsidiary books of Mr. Kamran, post them into the Ledger and prepare a Trial Balance.

1990

1. **Jan. 1 Mr. Kamran Started business of shoes with cash Rs. 500000.**
2. **Jan. 1 Opened a current Account with ABL and deposited Rs. 250,000.**
3. **Jan. 1 Goods purchased (Shoes Purchased) from Milli Shoes Co. for Rs. 50,000 for Cash.**


STAGE 1. TRANSACTIONS WITH ORIGINAL DOCUMENT
Credit purchases from suppliers (Invoice received from suppliers)
Credit Sales to customers (second copies of our own invoices)
Goods returned to suppliers (our Purchases Returns)
Goods Returned by customers (our Sales Returns)
Residuary Transactions e.g. Purchase of assets on credit etc.
Cash and Cheques received from the debtors
Payments made through Cash and Cheques
Petty Cash Vouchers
STAGE 2. THE ORIGINAL BOOKS OF ENTRY
Purchase Book
Sales Book
Purchases Returns Book
Sales Returns Book
Proper Journal
Dr. Cr.
Dr. Cash Book Cr.
Petty Cash Book
Cash Book Credited
STAGE 3. POSTING IS MADE IN LEDGER ACCOUNTS
Purchase A/c debited
Creditors A/c credited
Customers A/c debited
Sales A/c credited
Creditors A/c debited
Purchases Returns A/c credited
Sales Returns A/c debited
Debtors A/c credited
Required A/c debited
Required A/c credited
Concerned A/c debited
Concerned A/c credited
Required A/c debited
STAGE 4. TRIAL BALANCE IS TAKEN OUT
{Debit Balances and Credit Balances}
5(a) Trading Account
Direct Expenses balances
Gross profit
Direct Revenue balances
5(b) Profit and Loss A/c
Indirect expenses
Net profit
Gross profit
Indirect Revenues
5(c) Balance Sheet
Liabilities including capital
Assets

4.	Jan. 3	Goods purchased from Services Industries Ltd. for Rs. 45000 on credit.
5.	Jan. 3	Purchased furniture for Rs. 30,000 from Punjab Furniture Store on credit.
6.	Jan. 3	Spent Rs. 10,000 on electric fitting and Cash paid.
7.	Jan. 4	A sum of Rs. 50000 was spent on air–conditioning the shop, payment made by cheque.
8.	Jan. 5	Goods sold for Cash Rs. 15500.
9.	Jan. 5	Goods sold to Waseem for Rs. 40,000 on credit.
10.	Jan. 6	Goods returned to Service Industries Ltd. Rs. 5000 being defective.
11.	Jan. 7	Payment made to Service Industries by cheque Rs. 30,000.
12.	Jan. 8	Goods returned by Waseem Rs. 10800.
13.	Jan. 9	Cash received from Waseem Rs. 29000 in full settlement of his account.
14.	Jan. 10	Payment made by cheque to Service Industries Ltd. Rs. 9900 in full settlement of their account.
15.	Jan. 11	Goods sold for Cash Rs. 30,000.
16.	Jan. 12	Cash paid into the bank Rs. 20,000.
17.	Jan. 13	Sold goods to X & Co. for Rs. 15000 on credit.
18.	Jan. 14	Printing charges paid by Cheque Rs. 15000.
19.	Jan. 15	Goods worth Rs. 2000 were taken away by the proprietor for his private use.
20.	Jan. 16	Cash received from X & Co. Rs. 10800.
21.	Jan. 17	Stationery purchased for Cash Rs. 1500.
22.	Jan. 20	Goods purchased for Cash Rs. 60,000.
23.	Jan. 22	Carriage paid on goods purchased Rs. 2000.
24.	Jan. 24	Wages paid on goods purchased Rs. 1500.
25.	Jan. 27	Building Rent paid by Cheque Rs. 5000.
26.	Jan. 28	Salaries paid to employees Rs. 15000 by cheque.
27.	Jan. 30	Sold goods for Cash Rs. 25000.
28.	Jan. 31	Cash received from X & Co. Rs. 4000 in full settlement of their account.

Solution:

First notice the following points:

(a) The following transactions should be recorded in the three column Cash Book.

Transactions No. 1, 2, 3, 6, 7, 8, 11, 13, 14, 15, 16, 18, 20, 21, 22, 23, 24, 25, 26, 27, 28

(b) The following transaction should be recorded in the Purchases Book.

No. 4

(c) In Sales Book.

No. 9, 17

(d) In Purchases Returns Book.

No. 10

(e) In Sales Return Book.

No. 12

(f) In Journal Proper.

No. 5, 19.

JOURNAL PROPER

Date	Description	L/F	Dr. Amount Rs.	Cr. Amount Rs.
1990				
Jan. 3	Furniture Account Dr.	20	30,000	
	Punjab Furniture Stores Account	18		30,000
	(Being goods taken away by the owner for private use)			
Jan. 15	Drawing Account Dr.	21	2000	
	Purchase Account	2		2000
	(Being goods taken away by the owner for private use)			
			32000	32000

Dr. **THREE COLUMN CASH BOOK** Cr.

Cash balance Rs. 219300
Bank balance Rs. 145100

Date	Particulars	V. No.	L.F	Dis. allowed Rs.	Cash Rs.	Bank Rs.	Date	Particulars	V. No.	L.F.	Dis. received Rs.	Cash Rs.	Bank Rs.
1990							1990						
Jan. 1	Capital A/c		1		500000		Jan. 2	Bank A/c		C		250000	
Jan. 2	Cash A/c		C			250000	Jan. 3	Purchase A/c		2		50000	
Jan. 5	Sales A/c		6		15500		Jan. 4	Electric fitting A/c		4		10000	
Jan. 9	Waseem A/c		9	200	29000		Jan. 4	Air-conditions A/c		5			50000
Jan. 11	Sales A/c		6		30000		Jan. 7	Service Ind. A/c		8			30000
Jan. 12	Cash A/c		C			20000	Jan. 10	Service Ind. A/c		8	100		9900
Jan. 15	X & Co.		11		10800		Jan. 12	Bank A/c		C		20000	
Jan. 30	Sales A/c		6		25000		Jan. 14	Printing charges A/c		10			15000
Jan. 31	X & Co.		11	200	4000		Jan. 17	Stationery A/c		12		1500	
							Jan. 20	Purchase A/c		2		60000	
							Jan. 22	Carriage A/c		13		2000	
							Jan. 24	Wages A/c		14		1500	
							Jan. 27	Rent A/c		16			5000
							Jan. 28	Salaries A/c		17			15000
								Balances c/d				219300	145100
				400	614300	270000					100	614300	270000

PURCHASES BOOK

Date		V/No	L/F	Details Rs.	Amount Rs.
1990					
Jan. 3	Service Industries Ltd.	–	8	——	45000
	Purchase Account Dr				45000

SALES BOOK

Date		V/No	L/F	Details Rs.	Amount Rs.
1990					
Jan. 5	Waseem	–	9	——	40,000
Jan. 13	X & Co.		11	——	15000
	Sales Account Cr.				55000

SALES RETURNS BOOKS

Date		V/No	L/F	Details Rs.	Amount Rs.
1990					
Jan. 8	Waseem	–	9	——	10800
	(Being goods returned)				
	Sales Account A/c Dr.		22		10800

PURCHASES RETURNS BOOK

Date		V/No	L/F	Details Rs.	Amount Rs.
1990					
Jan. 6	Service Industries Ltd.	–	8	——	5000
	(Being goods returned)				
	Purchase Returns A/c Cr.		23		5000

POSTING IN LEDGER

CAPITAL ACCOUNT: (Folio No. 1)

Credit balance Rs. 500,000

Dr. Cr.

Date	References	J/f	Amount Rs.	Date	References	J/F	Amount Rs.
1990	Balance c/d		500000	1990 Jan. 1	Cash A/c	—	500000
			500000				500000

PURCHASE ACCOUNT (Folio No. 2)

Debit balance Rs. 153,000

Date	References	J/f	Amount Rs.	Date	References	J/F	Amount Rs.
1990				1990			
Jan. 3	Cash A/c	–	50000	Jan. 15	Drawing A/c		2000
Jan. 3	as per P. Book		45000	Jan. 31	Balance c/d		153000
Jan. 20	Cash A/c		60000				
			155000				155000

ELECTRIC FITTING ACCOUNT (Folio No. 4)

Debit balance Rs. 10,000

Date	References	J/f	Amount Rs.	Date	References	J/F	Amount Rs.
1990				1990			
Jan. 3	Cash A/c	–	10,000	Jan. 31	Balance c/d		10,000
			10,000				10 ,000

AIR–CONDITIONER ACCOUNT (Folio No. 5)

Debit balance Rs. 50,000

Date	References	J/f	Amount Rs.	Date	References	J/F	Amount Rs.
1990				1990			
Jan. 4	Bank A/c	–	50000	Jan. 31	Balance c/d		50000
			50000				50000

SALES ACCOUNT (Folio No. 6)

Credit balance Rs. 125500.

Date	References	J/f	Amount Rs.	Date	References	J/F	Amount Rs.
1990				1990			
Jan. 31	Balance c/d		125500	Jan. 31	Cash A/c		15500
				Jan. 31	as per S Book		55000
				Jan. 31	Cash A/c		30000
				Jan. 31	Cash A/c		25000
			125500				125500

ERVICE INDUSTRIES LTD. ACCOUNT (Folio No. 8)

No Balance

Date	References	J/f	Amount Rs.	Date	References	J/F	Amount Rs.
1990				1990			
Jan. 7	Bank A/c		30000	Jan. 3	Purchase A/c		45000
Jan. 10	Bank A/c		9900				
Jan. 10	Discount A/c		100				
Jan. 10	Purchases Return A/c		5000				
			45000				45000

WASEEM ACCOUNT (Folio No. 9)

No Balance

Date	References	J/f	Amount Rs.	Date	References	J/F	Amount Rs.
1990				1990			
Jan. 5	Sales A/c	–	40000	Jan. 8	Sales Return A/c		10800
				Jan. 9	Cash A/c		29000
				Jan. 9	Discount A/c		200
			40000				40000

PRINTING CHARGES ACCOUNT (Folio No. 10)

Debit balance Rs. 1500

Date	References	J/f	Amount Rs.	Date	References	J/F	Amount Rs.
1990				1990			
Jan. 14	Bank A/c	–	15000	Jan. 31	Balance c/d		15000
			15000				15000

X & CO. ACCOUNT (Folio No. 11)

No Balance

Date	References	J/f	Amount Rs.	Date	References	J/F	Amount Rs.
1990				1990			
Jan. 13	Sales A/c	–	15000	Jan. 16	Cash A/c		10800
				Jan. 31	Cash A/c		4000
				Jan. 31	Discount A/c		200
			15000				15000

STATIONERY ACCOUNT (Folio No. 12)

Debit balance Rs. 1500

Date	References	J/f	Amount Rs.	Date	References	J/F	Amount Rs.
1990				1990			
Jan. 17	Cash A/c	–	1500	Jan. 31	Balance c/d		1500
			1500				1500

CARRIAGE ACCOUNT (Folio No. 13)

Debit balance Rs. 2000

Date	References	J/f	Amount Rs.	Date	References	J/F	Amount Rs.
1990				1990			
Jan. 22	Cash A/c	–	2000	Jan. 31	Balance c/d		2000
			2000				2000

WAGES ACCOUNT (Folio No. 14)

Debit balance Rs. 1500

Date	References	J/f	Amount Rs.	Date	References	J/F	Amount Rs.
1990				1990			
Jan. 24	Cash A/c		1500	Jan. 31	Balance c/d		1500
			1500				1500

RENT ACCOUNT (Folio No. 16)

Debit balance Rs. 5000

Date	References	J/f	Amount Rs.	Date	References	J/F	Amount Rs.
1990				1990			
Jan. 27	Cash A/c	–	5000	Jan. 31	Balance c/d		5000
			5000				5000

RENT ACCOUNT (Folio No. 17)

Debit balance Rs. 15000

Date	References	J/f	Amount Rs.	Date	References	J/F	Amount Rs.
1990				1990			
Jan. 28	Cash A/c	–	15000	Jan. 31	Balance c/d		15000
			15000				15000

PUNJAB FURNITURE STORE ACCOUNT (Folio No. 18)

Credit balance Rs. 30000

Date	References	J/f	Amount Rs.	Date	References	J/F	Amount Rs.
1990				1990			
Jan. 31	Balance c/d		30000	Jan. 3	Furniture A/c		30000
			30000				30000

FURNITURE ACCOUNT (Folio No. 20)

Debit balance Rs. 30000

Date	References	J/f	Amount Rs.	Date	References	J/F	Amount Rs.
1990 Jan. 3	Punjab Furniture Store A/c		30000	1990 Jan. 31	Balance c/d		30000
			30000				30000

DRAWING ACCOUNT (Folio No. 21)

Debit balance Rs. 2000

Date	References	J/f	Amount Rs.	Date	References	J/F	Amount Rs.
1990 Jan. 15	Purchase A/c		2000	1990 Jan. 31	Balance c/d		2000
			2000				2000

SALES RETURNS ACCOUNT (Folio No. 22)

Debit balance Rs. 10800

Date	References	J/f	Amount Rs.	Date	References	J/F	Amount Rs.
1990 Jan. 8	as per S.R.B.		10800	1990 Jan. 31	Balance c/d		10800
			10800				10800

PURCHASES RETURNS ACCOUNT (Folio No. 23)

Credit balance Rs. 5000

Date	References	J/f	Amount Rs.	Date	References	J/F	Amount Rs.
1990 Jan. 31	Balance c/d		5000	1990 Jan. 6	as per P.R.B.		5000
			5000				5000

DISCOUNT RECEIVED ACCOUNT (Folio No. 25)

Credit balance Rs. 100

Date	References	J/f	Amount Rs.	Date	References	J/F	Amount Rs.
1990				1990			
Jan. 31	Balance c/d		100	Jan. 31	as per discount column of Cash Book		100
			100				100

DISCOUNT ALLOWED ACCOUNT (Folio No. 26)

Credit balance Rs. 400

Date	References	J/f	Amount Rs.	Date	References	J/F	Amount Rs.
1990				1990			
	As per discount column of Cash Book		400	Jan. 31	Balance c/d		400
			400				400

MR. KAMRAN
Trial Balance as on 31st Jan., 1990

S. No.	Account Titles	Debit Rs.	Credit Rs.
1.	Cash Account	219300	
2.	Bank Account	145100	
3.	Capital Account		500,000
4.	Purchases Account	153000	
5.	Electric Fitting Account	10,000	
6.	Air–Conditioner Account	50,000	
7.	Sales Account		125500
8.	Printing Charges Account	15000	
9.	Stationery Account	1500	
10.	Carriage Account	2000	
11.	Wages Account	1500	
12.	Rent Account	5000	
13.	Salaries Account	15000	
14.	Punjab Furniture Store A/c		30,000
15.	Furniture Account	30,000	
16.	Drawing Account	2000	
17.	Sales Returns Account	10800	
18.	Purchases Returns Account		5000
19.	Discount Received Account		100
20.	Discount Allowed Account	400	
		660600	660600

INFORMATION AVAILABLE FROM THE TRIAL BALANCE:

The Trial Balance is a list of ledger accounts balances and it gives us the following information;

1. Capital Account Balance; (Cr.): – a liability.

   It shows us the investment made by the proprietor into the business.
2. Cash Account Balance (Dr):– an asset

   It represents the amount of Cash in hand at the end of the month.
3. Bank Account Balance (Dr.):- an asset

   It represents our deposits with the bank at the end of the month.
4. Purchase Account Balance (Dr.):- an expense

   It reflects the total purchases that have been made during the month.
5. Electric Fitting Account balance (Dr.):- an asset

   It shows the amount spent on electric fittings e.g. cable, bulbs, tube lights etc.
6. Air–conditioner Account balance (Dr.):- an asset

   It shows the total amount spent on installation of an air–conditioner.
7. Sales Account Balance (Cr.):- a revenue

   It gives us the information about the total sales that have been made during the year.
8. Printing Charges Account Balance (Dr.):- an expense

   It shows the amount spent on the printing of various books of accounts.
9. Stationery Account Balance (Dr.):- an expense

   It shows the stationery used in the business during the month.
10. Carriage Account balance (Dr.):- an expense

    It shows the amount spent on carrying the goods to the go down of the business.
11. Wages Account Balance (Dr.):- an expense

    It represents the amount spent on the loading and un–loading of the goods.
12. Rent Account Balance (Dr.):- an expense

    It shows the amount paid to the Land–lord or owner of the building or rent of the month.
13. Salaries Account Balance (Dr.): an expense

    It shows the amount paid to the employees of the business as salaries for the month.
14. Punjab Furniture Stores Account balance (Cr.):- a liability.

    It shows the amount payable to a creditor of the business.
15. Furniture Account balance (Dr.):- an asset.

    It shows the money spent on the purchase of an asset for the business.

16. Drawings Account balance (Dr.):- a decrease in liability.

    It shows a reduction in owner's equity.

17. Sales Returns Account Balance (Dr.):- a decrease in revenue.

    It shows the value of goods that have been returned by the customers during the month.

18. Purchase Return Account Balance (Cr.):- a decrease in expense.

    It shows the value of goods that have been returned to the suppliers during the month.

19. Discount Received Account Balance (Cr.):- a revenue.

    It shows the total amount of discount received from the creditors during the month.

20. Discount Allowed Account balance (Dr.):- an expense

    It shows the total amount of discount that has been allowed to the debtors during the month.

CHAPTER - 10

FINAL ACCOUNTS: THE COMPLETION OF ACCOUNTING CYCLE

FINAL ACCOUNTS: THE COMPLETION OF ACCOUNTING CYCLE

Every businessman goes into a business with the idea of making profit, which is the reward of his efforts. He tries his best to get more and more profit at the smallest economic cost.

The role of accounting is to accumulate accounting data in such a manner that the amount of profit made or loss sustained during a particular period could be ascertained. The **"Final Accounts"** enable us to check on the conduct of the business, and to discover whether it is being run profitably. They are the means of conveying to the owner/owners, management, creditors, and interested outsiders a concise picture of profitability and financial position of the business. The Preparation of Final Accounts is not the first stage of an accounting cycle but they are the final products of the accounting cycle, that is why, they are called 'Final Accounts'.

These accounts summaries all the accounting information recorded in the original books of entry and the ledger consisted of hundreds or thousands of pages. The Final Accounts or Financial Statements' consist of,

1. Trading and profit and Loss Account or Income Statement, which is prepared to know the profit earned or loss suffered by the business during a specific period.
2. Balance sheet, which is prepared to know the financial position of the business on a particular date.

These two accounts or statements are collectively known as **"Final Accounts or Financial Statements"**.

TRIAL BALANCE

A STARTING POINT FOR FINAL ACCOUNTS

We know the Trial Balance is simply a list of ledger accounts balances at the end of an accounting period. This summary of the ledger at the end of an accounting period, is a convenient starting point in the preparation of the Final Accounts. i.e. Trading and profit and loss Account, and Balance Sheet.

A Trial Balance usually contains the following types of balances,

1. Balances from Expenses Accounts
2. Balances from Revenue Accounts
3. Balances from Assets Accounts
4. Balances from Liabilities Account
5. Balance from Capital or Owner's Equity Account

→ The first two types of balances are transferred to Trading and Profit and Loss Account to find out profit or loss.

→ The other three types of balances are transferred to the Balance Sheet to know the financial position of the business.

NOTE:

The Trading and profit and Loss Account and Balance sheet are discussed in details later in this chapter.

Thus we prepare from the Trial Balance a Trading and Profit and Loss Account by matching Revenue balances with Expenses balances and by the time we have finished, we have a very much smaller Trial Balance, which is then arranged into a 'Balance Sheet'. So,

Profit = Revenue – All expenses:

WHAT DO WE MEAN BY REVENUE:

In common Language "Revenue" means Tax or income. But in a business concern revenue means "Sale proceeds of goods or services or it is the price of goods sold or services rendered to the customers. Again, according to American Accounting Association, "Revenue – is the monetary expression of the aggregate of products or services transferred by an enterprise to its customers during a period of time". When a business delivers goods to its customers or renders services to them, it either receives immediate payment in cash or acquires an account receivable (Debtor) which will be collected and thereby become cash within a short time. The revenue for a given period is equal to the inflow of Cash and receivables (Debtors) from sales made in that period. Thus,

Revenue = Amount received in Cash + Receivable

SOURCES OF REVENUE:

The sources of revenue are:

1. Sale proceeds of goods or services. (Sales A/c).
2. Interest received on investment. (Interest A/c Cr. balance)
3. Dividend received on share (Dividend A/c)
4. Discount received from creditors. (Discount Received A/c Cr. balance)
5. Commission received from customers. (Commission A/c Cr. balance)
6. Profit on sale of assets (except goods)

If may be mentioned here that various terms are used to described different types of revenue. For example business which sells goods rather than services will use the term "Sales" to describe the revenue; revenue earned by a property Dealer may be called "Commission earned; in the professional practice of layers, charted accountants, the revenue is called "fees earned".

Every business has one or two major sources of revenue and may also, have some minor sources of revenue also. So, the sources of revenue may be divided into two categories.

1. OPERATIONAL SOURCE OR MAJOR SOURCE OR DIRECT SOURCE OF REVENUE:

The revenue earned out of normal business activities belongs to this source. For example, for a trader, sale proceeds of goods is a major source of revenue; for a property Dealer, commission earned is a major source of revenue; for a lawyer, fees earned is a major source of revenue.

2. FINANCIAL SOURCES OR MINOR SOURCES OR INDIRECT SOURCES OF REVENUE:

Any revenue arising from sources other than normal business activities belongs to this category. e.g. Interest, dividend, profit on sale of fixed assets etc.

Thus for a trader;

Revenue

- Direct source of Revenue e.g. Sales proceeds of goods (Sales A/c)
- Indirect or minor sources of Revenue: e.g. interest received Dividend received. Commission received Discount received etc.

EXPENSES:

Expenses means the expired cost incurred for earning revenue of a certain accounting period. They are the cost of the goods and services used up in the process of obtaining revenue. In other words, it becomes possible to earn revenue with the help of expenses. For example, purchase of goods, wages salaries, rent, carriage, customs duty etc. we have to incur all these expenses in order to earn revenue.

Expenses are mainly divided into two categories;

(1) Direct Expenses

(2) Indirect Expenses.

1. DIRECT EXPENSES:

Expenses connected with purchases of goods are known as "Direct expenses". For example, Freight, insurance of goods in transit, carriage, wages, customs duty import duty, Octori duty etc. Without incurring these expenses, it is not possible to bring the goods from the purchase point to the go–down of the business. Such expenses are collectively known as direct expenses.

2. INDIRECT EXPENSES:

All the expenses other than direct expenses are assumed as indirect expenses. Such expenses have no relationship with purchase of goods. For example, rent of building, salaries to employees, legal charges, insurance of building, depreciation, printing charges etc. so

Expenses

Direct Expenses: e.g.	Indirect Expenses
purchases price of goods.	salaries paid.
Carriage on goods purchased,	Rent paid.
wages on goods	Insurance of building
Insurance of goods in transit.	Printing charges.
customs duty.	Legal charges etc.
Freight etc.	

MATCHING REVENUE AND EXPENSES:

To determine net profit for any particular accounting period, we use the **"matching principle".** The word matching refers to the close relationship that exists between certain expenses and the revenue realised as a result of incurring these expenses. In other words, revenues of the relevant accounting period should be matched against the expenses of the same period to ascertain profits or losses made by the business. In the form of an equation it may be stated that;

Profit = Revenue – Expenses.

Again, it should be noted that this year's expenses are associated with this year's revenue. We do not compare this year's expenses with last year's revenue because these is no close relationship between the two.

TRADING ACCOUNT:

It has already been discussed that every business concern ascertain profit or loss of the business at the end of the year through the Final Accounts. Business Concerns may be of the following two types:

(1) TRADING CONCERNS:

Trading concerns are those which do not manufacture goods, rather, they buy finished goods from the manufacturer or wholesaler and sell them to retailer or direct to customers. There are four stages in the Final Accounts of a trading Concern:

(a) Trading Account:

This shows gross result (Gross profit or Gross Loss) of the business.

(b) Profit and Loss Account:

This shows net result (net profit or net loss) of the business.

(c) Profit and Loss Appropriation Account:

This show how the net profit or loss of the business has been distributed or disposed off. This is not prepared in the case of sole proprietorship business.

(d) Balance Sheet:

This discloses the financial position of the business.

2. MANUFACTURING CONCERNS:

Manufacturing concerns are those which produce or manufacture goods i.e. convert raw material into finished goods. They sell the goods to the wholesaler or dealers. There are five stages in the Final Accounts of a manufacturing concern:

(a) Manufacturing Account – this shows the cost of goods manufactured.

(b) Trading Account.

(c) Profit and Loss Account.

(d) Profit and Loss Appropriation Account.

(e) Balance Sheet.

All the above mentioned stages are collectively known as Final Accounts or Financial Statement.

Profit or Loss of every business is generally determined in two stages. In the first stage Gross result (Gross profit or Gross loss) is ascertained and in the second stage net profit or net loss is ascertained.

1. GROSS PROFIT OR LOSS:

Gross profit is ascertained by deducting cost of goods sold (all direct expenses like purchases, carriage, customs duty, sock charges, octori duty etc.) from sales.

Gross profit = Total sales – All direct expenses or Cost of goods sold

For example, suppose Salman purchased some goods for Rs. 10,000 and paid Rs. 200 on account of carriage and Rs. 100 as octori duty. He sold the goods for Rs. 14000. Now, the cost of goods sold will be Rs. 10300 (10,000 + 200 + 100) and Gross profit will be Rs. 3700.

Gross profit = Total Sales – Cost of goods sold

3700 = 14000 – 10300 (10,000 + 200 + 100)

2. NET PROFIT OR LOSS:

It is ascertained by deducting all indirect expenses (the expenses incurred for running the business and selling the goods) from the Gross profit.

Net profit = Gross profit – All indirect expenses.

Suppose, in the above example Salman paid Rs. 1000 as salaries and Rs. 500 as rent. His net profit will be Rs. 2200.

Net profit = 3700 – (1000 + 500) = Rs. 2200

Thus the account which is prepared for determining gross profit or gross loss of a business concern, is called **"Trading Account"** and the account which is prepared for determining net profit or net loss of a business concern is called **"Profit and Loss Account".**

It should be noted that the result of the business determined through 'Trading A/c is not the true result. The true result is the net profit or the net loss which is determined through profit and Loss Account. The profit and Loss A/c will be discussed later in this chapter.

FEATURES:

The **Trading Account** has the following features;

1. It is the first stage of the Final Accounts of a trading concern.
2. It is prepared on the last day of an accounting period.
3. Only direct revenue and direct expenses are considered in it.
4. Direct expenses are recorded on its debit side and direct revenue on its credit side.
5. All items of direct expenses and direct revenue concerning current year are taken into account. But no item relating to past or next year is considered in it.
6. If its credit side exceeds – it represents Gross profit and if debit side exceeds – it shows Gross Loss.

WHY IS TRADING ACCOUNT PREPARED?

We have already discussed that, the profit or loss determined by a Trading A/c is the gross result of the business but not the true result. Then a question arises – what is the use of preparing a Trading Account? The Trading Account is necessary because it has the following advantages.

1. Gross profit of a business is very important data, since all business expenses are met out of it. So the amount of gross profit should be adequate to meet all the indirect expenses of a business.

2. The amount of net sales can be determined through this account. Gross sales can be ascertained forms sales A/c in the ledger, but net sales cannot be so obtained. The true sale of a business is net sales – not gross sales. Net sales are determined by deducting sales returns from gross sales in Trading A/c.

3. The success or failure of a business can be ascertained by comparing net sales of the current year with that of the last year. It should be noted that an increase in the amount of net sales of the current year over the last year may not be regarded as a sign of success, since sales may increase because of rise in price level.

4. Percentage of gross profit on net sales can be easily determined from Trading A/c. This percentage is a very important yardstick for measuring the success or failure of a business. Compared to last year, if the rate increases, it indicates success; on the other hand if the rate decreases, it is an indication of failure.

5. Percentage of different items of buying expenses (direct expenses) on gross profit can be easily determined and by comparing the percentage of the current year with that of the previous year the variations can be ascertained. An analysis of variances will disclose their causes which will help in controlling the amount of expenses.

6. Inventory or stock turnover can be determined from Trading A/c. The success or failure of a business can be measured by this rate. High rate indicates a favorable sign i.e. goods are sold soon after their purchase. On the other hand, low rate signifies deterioration, i.e. goods are sold long after their purchase.

METHOD OF PREPARATION OF TRADING ACCOUNT:

We know, Trial Balance is a list of all ledger accounts balances, so all the necessary information for preparation of a Trading A/c is available from the Trial Balance. As gross profit or gross loss of a particular period is determined through Trading Account. So it's heading will be as follows:

XYZ & Co.
Trading Account for the year ended 31.12.1990
(If accounting period ends on 31.12.1990)

From the Trial Balance the balances of opening stock A/c, Purchase A/c, Returns Inward A/c and of all direct expenses are transferred on the debit side of the Trading A/c, and the balances of Sales A/c, Returns outward A/c and closing stock A/c are transferred on the credit side of the Trading A/c.

If the credit side of a Trading A/c exceeds the debit side, the result is "Gross Profit", and if debit side exceeds the credit side, the result is "Gross Loss". The Performa of a Trading Account is shown below;

NAME OF BUSINESS

Trading Account for the year ended ......

Dr. **Cr.**

		Rs.			Rs.
Stock (opening)		....	Sales	....	
Purchases	....	....	Less Returns	....	....
Less returns	....	....	Stock (closing)		....
Carriage Inward		....	Gross Loss (Transferred to P & L A/c).		....
Wages		....			
Insurance in transit		....			
Custom duty		....			
Clearing charges		....			
Clearing charges		....			
Freight Inward		....			
Transportation Inward		....			
Excise duty on goods manufactured		....			
Royalty		....			
Dock charges		....			
Coal, Coke, Gas, Full		....			
Motive Power		....			
Oil, Water		....			
Gross profit (Transferred to P & L A/c)		....			

If credit side exceeds the debit side = Gross profit

If debit side exceeds the credit side = Gross loss

NOTE:

It may be noted that on the debit side, all expenses relating to goods are recorded and on the credit side, revenues earned from the sale of these goods are recorded.

Different items of Trading Account are discussed below; (Debit side):

(1) STOCK (OPENING):-

It is unsold part of the last year's purchases. It is available from stock A/c in the ledger and has debit balance in the Trial Balance. It indicates the value of goods lying unsold at the end of last year. Now it will become a part of the current year's purchases. Last year's closing stock is current year's opening stock.

Again, current year's closing stock will be next year's opening stock. In the case of a newly set up business, there cannot, however, be any opening stock.

(2) PURCHASES:

It is the value of all goods purchased in the current accounting year and it is available from Purchase A/c in the Ledger. 'Purchase returns' are deducted from Purchases and net purchases are shown on the debit side of the Trading A/c.

(3) CARRIAGE INWARD:

It means the expenses incurred on bringing purchased goods from the place where they have been purchased, to the shop or go down of the business. It should be remembered that expenses for sending sold goods to customer's shop or house are not recorded in this account. They are debited to carriage outward A/c, an indirect expense, which is transferred to profit and loss A/c. Carriage Inward is transferred to the debit side of the Trading A/c. Sometimes in examination, only the word "Carriage" is mentioned. In that case it should be regarded as carriage Inward and debited to the Trading A/c.

(4) WAGES:

This refers to the remuneration paid to the workers for the loading and unloading of Purchased goods or it is the remuneration paid to the workers who are directly engaged in productive activities. Any how, this is an expense which is directly related with saleable goods and is always debited to the Trading Account.

In this connection, the distinction between salaries and wages should be noted carefully. Salaries refer to remuneration paid to employees not engaged in productive activities and being indirect expenses are debited to P & L A/c. Sometimes in examination problems wages and salaries are given together as a single item, instead of showing the two items separately. In such a case, if division is not possible, its treatment will depend on the order is which the two items have been grouped together. For example,

(a) **Wages and Salaries:** The whole amount is debited to the Trading A/c as salaries are assumed to be productive.

(b) **Salaries and Wages:** The whole amount is debited to P & L A/c as wages are assumed to be unproductive

(5) INSURANCE IN TRANSIT:

While bringing goods from outside, they may be destroyed or stolen in transit. Such loss may be insured against. The amount of premium paid to the 'Insurance Company' is debited to the Insurance in transit A/c and is transferred to the debit side of the Trading A/c being an expense connected with the purchase of goods.

In this connection, it should be noted that premium paid for insurance of building, plant machinery, furniture, stock etc. against loss by fire or accident is debited to P & L A/c being an indirect expense.

(6) CUSTOMS DUTY:

The duty imposed by Government on import & export of goods is known as customs duty. Customs duty is of two types–import duty & export duty. Duty paid on goods imported from abroad is known as import duty and is debited to the Trading A/c. But duty paid on goods exported (i.e. export duty) being expenses connected with sales, is debited to P & L A/c. So, import duty on goods purchased from abroad is a direct expense and export duty on goods sold is an indirect expense.

(7) CLEARING CHARGES:

In case of imports from abroad goods are cleared from ports. For this, port authorities charge something which is called clearing charges. This is a direct expense and is debited to Trading Account.

(8) FREIGHT INWARD:

Charges paid on bringing purchased goods from abroad through steamer, rail or air are known as freight inward. Being an expense connected with the purchase of goods, it is debited to the Trading A/c.

(9) TRANSPORTATION INWARD:

As discussed above.

(10) EXCISE DUTY ON GOODS MANUFACTURED:

Duty imposed by the Government on goods manufactured or produced within the country, is called excise duty. This being an expense connected with saleable goods or production, is debited to the manufacturing A/c or Trading A/c, as the case maybe.

(11) ROYALTY:

In a word, royalty means rent. A manufacturer has to pay such rent, when he acquires the right to produce an article. For example, amount payable to the owner of patent for the use of patent right, amount payable to the author of a book on acquiring the right to publish this book etc. It should be noted here that the royalty may be based on either production of goods or sale of goods. When the royalty is paid on production basis, it is debited to the Manufacturing A/c or the Trading A/c, as the case may be. But if the royalty is paid on sales basis, it debited to P & L A/c being an indirect expense. In the absence of any indication in the examination problems, it should be assumed to be based on product basis and debited to Manufacturing A/c or Trading A/c.

(12) DOCK CHARGES:

These are the dues imposed on ships and their cargoes when they are unloaded on the port. This is a direct expense and is debited to the Trading A/c.

(13) COAL, COKE, FUEL, GAS, OIL, MOTIVE POWER ETC.:

These items of expenditure being connected with production of goods (as required to run the Plant a Machinery) should be debited to the Manufacturing A/c or the Trading A/c as the case may be.

(14) OCTORI DUTY:

This is a duty which is imposed by the Municipal Corporation or the Municipal Committee when goods purchased enters its territory. So, when the goods are purchased from another city, this duty has to be paid. It is an expense connected with purchase of good and is debited to the Trading A/c.

(15) CONSUMEABLE STORES:

These are the expenses incurred to keep the machine in right condition and include engine oil, soft soap, cotton waste, oil grease and waste consumed in factory. The amount of such stores consumed during he year will be debited to the Trading A/c.

(16) MANUFACTURING EXPENSES:

All expenses incurred in manufacturing or producing the goods in a factory as factory insurance, factory rent, depreciation on factory building, lighting are direct expenses and are debited to Manufacturing A/c or Trading A/c as the case may be.

CREDIT SIDE:

1. SALES:

It is the value of all the goods sold during the current accounting year and it is available from the Sale A/c in the Ledger. It is a major source of revenue in a business which deals in goods. 'Sales returns' are deducted from Sales and the net sales are shown on the credit side of the Trading A/c.

2. STOCK (CLOSING):

It indicates the value of goods lying unsold at the end of the current accounting year. At the end of the year a list of unsold goods is prepared showing the quantity and value of each item. The total of the list represents the value of closing stock. The list should be prepared with utmost care and attention. Although closing stock is an asset, yet it is shown on the credit of the Trading A/c.

Why closing stock is shown in the Trading A/c?

Closing stock is shown on the credit side of the Trading A/c in order to make the comparison correct and logical between expenses and revenue. If it is not shown, the matching of expenses and revenue may be wrong. For example, suppose we purchased 100 units of a product @ of Rs. 10 per unit and sold all these units @ of Rs. 15 each. Our purchases are Rs. 1000 (100×10) and our sales are Rs. 1500 (100×15). Purchases are shown on the debit side of the Trading A/c and sales on the credit side resulting a gross profit of Rs. 500. This is a correct comparison. But, suppose, we sold only 80 units @ of Rs. 15 each. In that case our purchases are, again Rs. 1000 but our sales are Rs. 1200 and the gross profit is Rs. 200. But this is not the true gross profit because we matched the purchase price of 100 units with the sale price of 80 units only, which is not justified. The correct comparison will be as follows:

TRADING ACCOUNT

Purchases 100 × 10 =	1000	Sales = 80 × 15 =	1200
Gross profit	400	Closing stock:	
		20 × 10 200	
	1400		1400

Thus the correct gross profit is Rs. 400.

VALUATION OF CLOSING STOCK:

Closing stock is valued at the last date of accounting period by counting, measuring ot weighing the goods lying unsold in the shop or go down. On the basis of physical observation the stock lists are prepared and the value of total stock is calculated on the basis of unit value. Now the question is – how to value the unsold goods? A prudent accounting principle is the concept of "Conservatism", the basic point of which is – anticipate no profit, but provide for all possible losses. Under this concept the rule for valuing goods is.

LOWER OF COST OR MARKET PRICE (LCM):

Under this rule stock is valued at cost price or market price which ever is lower. Suppose, the cost price of stock is Rs. 1000 and the current market price is Rs. 1200. So there will be a profit of Rs. 200 next year, when the goods will be sold. But this profit cannot be considered in current year's account, because, the goods have not been sold in this year and hence, the profit has not been actually earned. It is an anticipated profit – there is no guarantee that this profit will be earned next year. If the unsold goods are valued at market price i.e. Rs. 1200. The anticipated profit of Rs. 200 will be included in this year's account. As a result current year's profit will be inflated by Rs. 200. If this profit is drawn by the proprietor and if for some reasons this profit is not actually realized in the next year, the working capital will decrease creating various problems. So, unsold goods should be valued at cost price i.e. Rs. 1000.

Suppose, if the market price is Rs. 900, then there will be a loss of Rs. 100 (1000 – 900) in the next year, when the goods will be sold. The goods have not been sold in the current year and the loss has not been actually incurred – it is a possible loss of the next year. Yet this loss will be considered in this current year's account according to the **Concept of Conservatism.** So the unsold goods will be valued at current market price i.e. Rs. 900.

Now the question is – What is cost price? The cost price is determined by the manufacturer and the trader in a different manner. To a manufacturer the cost price is the cost of production of unsold goods, while to a trader the cost price is the actual purchase price plus all direct expenses. Ascertainment of the value of unsold goods is very complicated and difficult, since goods are usually purchased at different rate at different times. Any how, there are three most common methods according to which unsold goods are valued;

(1) FIFO method (First in first out)

(2) LIFO method (Last in first out)

(3) Average Cost method.

Thus closing stock should be valued at cost price or current market price which ever is lower.

Normally closing stock is given outside the Trial Balance as it is valued on the last date of accounting period, in that case, it is to be shown on the credit side of Trading A/c and then on the asset side of Balance Sheet. But if it is given inside the Trial Balance, it is not to be shown on the credit side of Trading A/c but appears only in the Balance Sheet as an asset.

CLOSING ENTRIES: TRADING A/C AND DOUBLE ENTRY SYSTEM:

Trading A/c is a summary of direct expenses and direct revenue. The balances of all direct expenses accounts (opening stock A/c, purchases A/c, other direct expenses A/c) are transferred to the debit side of Trading A/c and those of Revenue Accounts are transferred to the credit side of Trading A/c. After the Trading A/c has been prepared, all the concerned accounts except stock A/c will be closed. Stock A/c is an asset A/c and it will leave a balance so long some goods remain unsold.

All expenses have debit balances and all revenue have credit balances.

Closing entries are passed at the end of every accounting period to close off the expenses A/c and Revenue A/c and to transfer their balances to the Trading A/c and Profit and Loss A/c. For example, suppose the Purchase A/c in the Trial Balance has a debit balance of Rs. 75000. When it is transferred to the Trading A/c in order to work out the Gross Profit, we close off the Purchase A/c by crediting it and Trading A/c is debited. In this way the debit balance of Purchase A/c is transferred on the debit side of Trading A/c and Purchase A/c is closed (has no balance).

Purchase A/c is shown below before and after its closure:

(a) Before it is closed

Purchase A/c

	Rs.		
Balance b/d	75000		

Purchase A/c is showing zero balance

(b) After it is closed.

Purchase A/c

	Rs.		Rs.
Balance b/d	75000	Trading A/c	75000
	75000		75000

Closing entry is,

Rs.

Trading Account .... Dr. 75000

Purchase Account 75000

(Being transfer of purchase figure to Trading A/c to determine Gross profit).

Trading A/c

Rs.	Rs.
Purchase A/c 75000	85000

In the same way, suppose sales A/c in the Trial Balance has a credit balance of Rs. 85000. Its credit balance is transferred to the credit side of Trading A/c by passing the following closing entry,

Rs.

Sales Account .... Dr. 85000

Trading Account 85000

(Being transfer of sales A/c balance to Trading A/c in order to determine gross profit).

Given below is the sales A/c before and after its closure.

(a) After it is closed

Sales A/c

	Rs.		
Trading A/c	85000		

Sales A/c is showing zero balance

(b) Before it is closed

Sales A/c

	Rs.		Rs.
		Balance b/d	85000

The result of these closing entries is that the Purchase Account and Sales Account no longer have balances on them, they are clear and showing nil balances.

So, Journal entries relating to Tiding A/c are passed as follows:

(1) Trading A/c .... Dr. x x x

Stock (Opening) A/c .... x x x

Purchase A/c .... x x x

All direct expenses A/c .... x x x

(2) Sales A/c .... Dr. x x x

Trading A/c .... x x x

(Being transfer of Sales A/c to Trading A/c)

(3) Stock (Closing) A/c .... Dr. x x x

Trading A/c .... x x x

(Being closing stock taken into account)

TRADING ACCOUNT

	Rs.		Rs.
Opening Stock	x x x	Sales A/c	x x x
Purchases	x x x	Closing Stock	x x x
Other direct expenses	x x x		

(4) Trading Account .... Dr. x x x

Profit & Loss Account .... x x x

(Being transfer of gross profit to P & L A/c)

(In case of gross loss reverse entry will as passed)

NOTE:

The Returns Inward A/c and Returns outward A/c have debit balance and credit balance respectively. According to the principle of double entry systems, they should also be transferred to Trading A/c through closing entries. But in practice, Returns Inward are shown on the credit side of Trading A/c as deduction from Sales and Returns outward on debit side of Trading A/c as deduction from purchases. Although the following entries are passed to close these accounts;

(1) Trading Account .... Dr. x x x

Returns Inward Account ...... x x x

(Being transfer of Returns Inwards to Trading A/c)

(2) Returns outward A/c ...... Dr. x x x

Trading Account .... x x x

(Being transfer of Returns outward to Trading A/c).

ILLUSTRATION NO. 1 32

The following are some ledger balances taken out from the Trial Balance of S. Rehman on 31st December 1990.

	Rs.		Rs.
Stock on 1.1.1990	**60,000**	**Returns outward**	**16000**
Purchases	**360,000**	**Returns Inward**	**30,000**
Carriage Inward	**24000**	**Sales**	**500,000**
Custom duty	**12000**		

The closing stock is valued at Rs. 100,000. Prepare a Trading A/c for the year ended 31st December 1990. Allow show the journal entries to close the above accounts.

Solution:

S. REHMAN

Trading A/c for the year ended 31.12.1990

Dr.		**Rs.**	**Cr.**		**Rs.**
Stock 1.1.1990		60,000	Sales	500,000	
Purchases	360,000		Less returns	30,000	470,000
Less returns:	16000	344000	Closing Stock		100,000
Carriage Inward		24000			
Custom duty		12000			
Gross Profit (transferred to P & L A/c)		130,000			
		570,000			570,000

Closing entries:

JOURNAL PROPER

Date	Description		L/F	Dr. Amount Rs.	Cr. Amount Rs.
1990					
Dec. 31	Trading Account	Dr.		486000	
	Stock (Opening) Account				60,000
	Purchase Account				360,000
	Returns Inward Account				30,000
	Carriage Inward				24,000
	(Being transfer of above A/c to Trading A/c)				12,000
Dec. 31	Sales Account	Dr.		500,000	
	Returns Outward Account	Dr.		16000	
	Trading Account				516000
	(Being transfer of above A/c to Trading A/c)				
Dec. 31	Stock (Closing) Account	Dr.		100,000	
	Trading Account				100,000
	(Being closing stock taken into account)				
Dec. 31	Trading Account	Dr.		130,000	130,000
	Profit & Loss A/c				
	(Being gross profit transferred to P & L A/c)				

Ledger: How accounts are closed?

Trading Account

	Rs.		Rs.
(1) Stock (opening)	60,000	Sales A/c (1)	500,000
(2) Purchases	360,000	Returns Outward A/c (2)	16,000
(3) Returns Inward	30,000	Stock (closing) (3)	100,000
(4) Carriage Inward	24,000		
(5) Custom duty	12,000		
Gross Profit (Transferred to P & L A/c)	130,000		
	616,000		616,000

Stock A/c has a debit balance of Rs 100,000

Stock Account

	Rs.		Rs.
Balance b/d (p. Stock)	60,000 (1)	Trading A/c	60,000
Trading A/c	100,000 (3)	Balance c/d (Cl. Stock)	100,000
	160,000		160,000

Purchase A/c

	Rs.		Rs.
Balance b/d	360,000 (2)	Trading A/c	360,000
	360,000		360,000

Returns Outward A/c

	Rs.		Rs.
Trading A/c	16000	Balance b/d	16000 (2)
	16000		16000

Returns A/c

	Rs.		Rs.
Balance b/d	30,000 (3)	Trading A/c	30,000
	30,000		30,000

Sales A/c

	Rs.		Rs.
Trading A/c	500000	Balance b/d	500000 (1)
	500000		500000

Carriage Inward A/c

	Rs.		Rs.
Balance b/d	24,000 (4)	Trading A/c	24,000
	24,000		24,000

Profit & Loss A/c

			Rs.
		(Gross Profit b/d) Trading A/c	130000

Customs duty A/c

	Rs.		Rs.
Balance b/d	12,000 (5)	Trading A/c	12,000
	12,000		12,000

It may be noted all accounts are showing nil balance except stock A/c which is showing debit balance of Rs. 100,000 being an asset and profit and Loss A/c showing credit 7balance of Rs. 130,000 being Gross profit transferred from Trading A/c.

ILLUSTRATION NO. 2 SL

The following is the Trial Balance extracted from the books of Naeem & Sons as on 31.12.1990. Prepare a Trading A/c for the year ended 31st December, 1990. Also prepare a Trial Balance with remaining balances.

		Dr. Rs.	Cr. Rs.
1.	Opening Stock	64,000	
2.	Purchases	4,60,000	
3.	Returns Inward	50,000	
4.	Carriage Inward	16,000	
5.	Salaries	96,000	
6.	Carriage Outward	10,000	
7.	Rent	72,000	
8.	Discount Allowed	8,000	
9.	Sundry Debtors	2,40,000	
10.	Plant & Machinery	3,60,000	
11.	Furniture	60,000	
12.	Drawings	18,000	
13.	Sundry Creditors		3,50,000
14.	Returns Outward		36,000
15.	Sales		7,40,000
16.	Capital		3,28,000
		14,54,000	14,54,000

Closing stock has been valued at Rs. 1,26,000

Solution:

NAEEM & SONS

Trading A/c for the year ended 31.12.1990

Dr. Cr.

		Rs.			Rs.
Opening Stock		64,000	Sales	7,40,000	
Purchases:	4,60,000		Less Returns:	50,000	6,90,000
Less Returns:	36,000	4,24,000	Closing Stock		1,26,000
Carriage Inward		16,000			
Gross Profit (Transferred to P&L A/c)		3,12,000			
		8,16,000			8,16,000

It may be noted that items No. 1,2,3,4,14, and 15 from the Trial Balance have been considered in Trading A/c. Now the Trial Balance with remaining items (balances) is given below:

TRIAL BALANCE (AFTER PREPARATION OF TRADING A/C).

		Dr. Rs.	Cr. Rs.
5.	Salaries	96,000	
6.	Carriage Outward	10,000	
7.	Rent	72,000	
8.	Discount Allowed	8,000	
9.	Sundry Debtors	2,40,000	
10.	Plant & Machinery	3,60,000	
11.	Furniture	60,000	
12.	Drawings	18,000	
13.	Sundry Creditors		3,50,000
16.	Capital		3,28,000
17.	Gross Profit		3,12,000
18.	Closing Stock	1,26,000	
		9,90,000	9,90,000

PROFIT AND LOSS ACCOUNT: STAGE 2

Items No. 1,2,3,4, 14, and 15 have disappeared.

New items are No. 17 and 18.

We have prepared a revised Trial Balance in illustration No. 2. Now, see what has happened to the Trial Balance? Because of the transfer of various items to the Trading Account, a number of balances shown on that Trial Balance have been cleared off completely, and, as a result, have disappeared from the Trial Balance. In addition two new items (closing stock and gross profit) have appeared in the revised Trial Balance. In the Trial Balance we still have a number of Expense Accounts which are to be considered in Profit and Loss Account.

We know, gross profit or loss of a business is ascertained through Trading A/c. Net profit or loss is determined by deducting all indirect expenses (business operating expenses) from the gross profit through Profit and Loss Account. Thus the *"account through which annual net profit or loss of a business is ascertained, is called Profit and Loss Account"*. It is also called as *"Income Statement"*.

METHOD OF PREPARATION:

The particulars required for preparing Profit and Loss Account are available from the Trial Balance. Only indirect expenses and indirect revenue are considered in it. This account starts from the result of Trading A/c (Gross profit is shown on the credit side of Profit and Loss A/c and Gross loss on the debit side). All indirect expenses from the Trial Balance are transferred on the debit side of it and all indirect revenue on the credit side of it. If the total of the credit side exceeds the total of debit side, the result is "Net Profit" and if the total of debit side exceeds the total of credit side, the result is net loss. As the net profit or net loss of a certain accounting period is determined through Profit and Loss A/c, so its heading is:

NAME OF BUSINESS

Profit & Loss Account for the year ended 31.12.1990

(If accounting period ends on 31.12.1990).

There is no hard and fast rule as to the order in which the items of expenses are shown in Profit & Loss A/c. Generally, the items of expenses are shown in the following sequence:

1. **OFFICE AND ADMINISTRATION EXPENSES:-**

These are the expenses connected with the management of the business e.g. Salaries of manager, accountant and office clerks, office rent, office stationery, office electric charges, office telephone etc.

2. **SELLING AND DISTRIBUTION EXPENSES:-**

These are the expenses which are directly or indirectly connected with sale and delivery of goods. These expenses vary with the sales i.e. they increase or decrease with the increase or decrease sale of goods, e.g. Advertisement, Carriage outward, Salesmen's Salaries and Commission, Discount allowed, Traveling expenses, Bad debts, Packing expenses, warehouse rent etc.

3. **FINANCIAL AND OTHER EXPENSES:-**

All other expenses and losses excepting those mentioned above are considered under this class.

The following is given the specimen of Profit and Loss A/c:

Dr. **Profit and Loss A/c for the year ended............** Cr.

	Rs.		Rs.
Trading A/c		Trading A/c	
Gross Loss (transferred)		(Gross profit transferred)	
OFFICE & ADMINISTRATION EXPENSES:		Interest Received	
Salaries		Rent Received	
Rent, rates, taxes		Discount Received	
Postage &Telegrams		Dividend Received	
Office Electric Charges		Bad debts Recovered	
Telephone Charges		Provision for Discount on Creditors	
Printing & Stationery		Miscellaneous revenue	
SELLING & DISTRIBUTION EXPENSES:		(Net loss transferred) to Capital A/c	
Carriage Outward			
Advertisement			
Salesmen's Salaries			
Commission			
Insurance			
Traveling Expenses			
Bad Debts			
Packing Expenses			
FINANCIAL AND OTHER EXPENSES:			
Depreciation			
Repairs			
Audit fee			
Interest paid			
Commission paid			
Bank charges			
Legal charges			
(Net profit transferred) to Capital A/c.			

Credit side more than debit side = Net Profit

Debit side more than credit side = Net Loss.

FEATURES:

1. This account is prepared on the last day of an accounting year in order to determine the net result of the business.
2. It is second stage of the Final Accounts.
3. Only indirect expenses and indirect revenue are shown in this account.
4. It starts with the closing balance of Trading A/c., i.e gross profit or gross loss.
5. All items of revenue concerning current year--whether received in cash or not--and all items of expenses-- whether paid in cash or not--are considered in this account. But no item relating to past or next year is included in it.

ILLUSTRATION NO. 3 5L

The revised Trial Balance in illustration No. 2, is given below. Prepare a Profit and Loss A/c for the year ended 31.12.1990. Also prepare a Trial Balance after preparation of P & L A/c.

REVISED TRIAL BALANCE

		Dr. Rs.	Cr. Rs.
5.	Salaries	96,000	
6.	Carriage Outward	10,000	
7.	Rent	72,000	
8.	Discount Allowed	8,000	
9.	Sundry Debtors	2,40,000	
10.	Plant & Machinery	3,60,000	
11.	Furniture	60,000	
12.	Drawings	18,000	
13.	Sundry Creditors		3,50,000
16.	Capital		3,28,000
17.	Gross Profit		3,12,000
18.	Closing Stock	1,26,000	
		9,90,000	9,90,000

Solution:

NOTE:

From revised Trial Balance items No. 5,6,7,8,17 are transferred to Profit and Loss A/c.

Naeem & Sons

Dr. **Profit and Loss A/c for the year ended 31.12.1990** Cr.

	Rs.		Rs.
OFFICE AND ADMINISTRATION EXPENSES:		Gross Profit	3,12,000
Salaries	96,000	(Transferred from Trading A/c.).	
Rent	72,000		
SELLING AND DISTRIBUTION EXPENSES:			
Carriage Outward	10,000		
Discount Allowed	8,000		
Net Profit	1,26,000		
(Transferred to Capital)			
	3,12,000		3,12,000

Trial Balance (after preparation of Trading A/c and Profit and Loss A/c.

		Dr. Rs.	Cr. Rs.
9.	Sundry Debtors	2,40,000	
10.	Plant & Machinery	3,60,000	
11.	Furniture	60,000	
12.	Drawings	18,000	
13.	Sundry Creditors		3,50,000
16.	Capital		3,28,000
18.	Closing Stock	1,26,000	
19.	Net Profit		1,26,000
		8,04,000	8,04,000

DIFFERENT ITEMS OF PROFIT AND LOSS ACCOUNT:

Some important items relating to Profit and Loss A/c are discussed below:

DEBIT SIDE:

1. ***Salaries:-*** Salaries mean the remuneration paid to employees who are connected with the management and conduct of the business. They are shown on the debit side of the Profit and Loss A/c.

   It must be remembered that the remuneration paid to the employees attached to a factory i.e. Factory Manager, Foreman, Storekeeper etc. is also known as salaries, but it is a direct expense and is debited to Trading A/c.

   If wages and salaries are shown in one account, its treatment will depend on the order in which the two items have been grouped. For example:

Wages & Salaries A/c	-- the whole amount is debited to Trading A/c.
Salaries & Wages	-- the whole amount is debited to P & L A/c.

2. ***Carriage outward:-*** It refers to the expenses incurred in sending sold goods to the customers. In this regard, the distinction between carriage inward and carriage outward should be noted. Carriage inward indicates the expenses of bringing goods/raw material purchased to the business and hence debited to Trading A/c. But carriage outward indicates the expenses incurred in sending sold goods and so debited to Profit and Loss A/c.

3. ***Trade Expenses:-*** It means small expenses of various natures. The amount of each item is so small that no separate account for individual item is opened. Instead, a combined account under the title "Trade Expenses A/c." is opened and all items of such expenditure are debited to that account. The account may also be designated as Miscellaneous Expenses A/c, General Expenses A/c, Sundry Expenses A/c or Petty Expenses A/c.

4. ***Printing & Stationery:-*** These are the expenses relating to printing paper, ink, pencil etc. They are debited to profit and loss A/c. If at the end of the year some stationery is lying unused, its value is ascertained and deducted from total stationery expenses and net expenses are shown on the debit side of Profit and Loss A/c. The unused stationery is regarded as stationery stock and is shown on the asset side of the Balance sheet.

5. ***Insurance:-*** Assets like Plant & Machinery, Building, Furniture etc may be insured against loss because of fire or any other accident. For this a sum of money is paid to the concerned insurance company every year as insurance premium. This is an indirect expense and is shown on the debit side of Profit and Loss A/c.

   It must be remembered that premium paid on account of insurance of proprietor's life cannot be regarded as business expenditure--it is owner's personal expenditure and so it is debited to Drawing A/c.

6. ***Advertisement:-*** These are the expenditures incurred to make advertisement of the products or goods of the business. Advertisement is made to promote the sales of the business. This, being an indirect expense, is shown on the debit side of Profit and Loss A/c.

7. ***Repairs:-*** These are the expenses incurred on the repair and maintenance of office building, office furniture and office equipment. They are shown on the debit side of Profit and Loss A/c. But all repairing charges for factory building, machinery will be debited to Trading A/c.

8. ***Packing Expenses:-*** Expenses incurred on boxes, bags and cartons etc. for dispatching goods to the customers, are known as packing expenses. It is an expense connected with sale of goods, so it is shown on the debit side of Profit and Loss A/c.

9. ***Bank Charges:-*** These are the expenses charged by the bank against the services it renders to us. These are shown on the debit side of Profit and Loss A/c.

10. ***Rates and Taxes:-*** These are the taxes imposed by the Government through Municipal Corporations, District Councils etc. for meeting public expenditure. These are also shown on the debit side of Profit and Loss A/c.

11. ***Depreciation:-*** It means the gradual decrease in the efficiency of an asset due to its use, wear and tear. It is a business loss and is debited to Profit and Loss A/c.

CREDIT SIDE:

1. ***Interest Received on Investment:-*** If there is any excess funds in a business, such fund is invested in Government securities or in debentures of a company and periodically interest is received from the government or company. Such interest is an indirect revenue and is shown on the credit side of Profit and Loss A/c.

2. ***Dividend Received on Shares:-*** Sometimes excess funds are invested in purchasing the shares of a company. Dividend is a part of company's profit which is given to the shareholders. Being the shareholder of the company, dividend is received which is an indirect revenue and is shown on the credit side of P & L A/c.

Difference between Trading Account and Profit and Loss Account:

Trading Account	Profit & Loss Account
1. It is the first stage of Final Accounts.	1. It is the second stage of Final Accounts.
2. It shows the Gross result (Gross profit or Gross loss) of the business.	2. It shows the net result (net profit or net loss) of the business.
3. All direct expenses (expenses connected with purchase or production of goods) are considered in it.	3. All expenses connected with sales and administration (indirect expenses) of business are considered.
4. It does not start with the balance of any Account.	4. It always starts with the balance of Trading Account.
5. Its balance (G.P or G.L) is transferred to P & L A/c.	5. Its balance (N.P or N.L) is transferred to Capital A/c in Balance Sheet.

Difference between Gross Profit and Net Profit:

Gross Profit	Net Profit
1. It is the excess of net sales over cost of purchase or manufacture (all expenses relating to purchase or manufacture of goods) of goods.	1. It is the excess of gross profit over all indirect expenses.
2. It is not true profit of the business.	2. It is true profit of the business.
3. It shows credit balance of Trading A/c.	3. It shows credit balance of Profit and Loss Account.
4. The progress of the business can be judged by the comparison of gross profit with net sales.	4. The profitability of business can be measured by the comparison of net profit with net sales.

CLOSING ENTRIES:

After preparation of Profit and Loss Account, all accounts relating to expenses and revenue are made to n. (closed) by passing closing journal entries. As we know, all accounts relating to expenses have debit balances and all accounts relating to revenue have credit balances. In closing entries, all accounts of expenses (having debit balance) are now credited (to close the accounts) and Profit and Loss A/c is debited. In this way all debit balances will be transferred on the debit side of Profit and Loss A/c. The entry to close accounts of expenses having debit balances is:

Profit and Loss A/c................................Dr. xxx

All Expense Accounts....................................xxx

Similarly, in closing entries, all accounts of revenue (having credit balances) are now debited (to close the accounts) and Profit and Loss A/c is credited. In this way all revenue accounts will be closed and their credit balances will be transferred on the credit side of Profit and Loss A/c. The entry for transfer is:

Revenue Accounts ....Dr. xxxxxx

Profit and Loss A/c xxx

Thus, on passing the closing entries all accounts of expenses and revenue will be closed, except profit and Loss A/c. The profit and Loss A/c will either show credit balance (net profit) or debit balance (net loss). Net profit or net loss will also be transferred to Capital A/c and, finally Profit and Loss A/c will be closed. For this the closing entries are:

1. When net profit (credit balance of P & L A/c) is transferred to capital A/c,

   Profit and Loss A/c ....Dr. xxx

   Capital A/c...xxx

2. When net Loss (Debit balance of P & L A/c) is transferred to capital A/c,

   Capital A/c..Dr. xxx

   Profit and Loss A/c. xxx

ILLUSTRATION NO. 4

From the following ledger balances on 31.3.1990, prepare a Profit and Loss A/c and also give the entries to close the above accounts.

		Rs.		Rs.
1.	**Trading A/c (Gross Profit)**	**24,000**	**Discount allowed**	**250**
	Salaries	**10,000**	**Discount received**	**100**
	Rent	**4,000**	**Interest received**	**50**
	Depreciation	**300**		

Solution:

Profit and Loss A/c for the year ended 31.3.1990

Dr. Cr.

	Rs.		Rs.
Salaries	10,000	Gross Profit b/d	24,000
Rent	4,000	(Transferred from	
Depreciation	300	Trading A/c)	
Discount Allowed	250	Discount Received	100
Net Profit	9,600	Interest Received	50
(Transferred to capital A/c)			
	24,150		24,150

Closing Entries:

Journal Proper

	Date	Particulars	Rs.	Rs.
	1990 31st Mar.	Profit and Loss A/c..Dr.	14,550	
		Salaries A/c		10,000
Accounts of expenses are credited and closed..		Rent A/c		4,000
		Depreciation A/c		300
		Discount Allowed		250
		(Being the transfer of above accounts to P & L A/c)		
Accounts of revenue are debited and closed.		Discount Received A/c..................................Dr.	100	
		Interest Received A/c..................................Dr.	50	
		Profit and Loss A/c		150
		(Being the transfer of revenue accounts to P & L A/c)		
Net profit transferred to capital and P&L A/c is closed.		Profit and Loss A/c..Dr.	9,600	
		Capital A/c		9,600
		(Being net profit transferred to capital A/c).		

Combined Trading and Profit and Loss A/c.

ILLUSTRATION NO. 5 5L

From the following Trial Balance, prepare a Trading and Profit and Loss A/c for the year ended 31.12.1990. Also prepare a revised Trial Balance after preparation of Trading & P & L A/c:

Items of, Balance Sheet			Dr. Rs.	Cr. Rs.
	1	**Capital**		**3,20,000**
B/S	2	**Drawings**	**90,000**	
B/S	3	**Building**	**3,00,000**	
B/S	4	**Machinery**	**80,000**	
B/S	5	**Bills Receivable**	**6,000**	
B/S	6	**Bills Payable**		
B/S	7	**Debtors (Accounts Receivable)**	**90,000**	**67,600**
B/S	8	**Creditors (Accounts Payable)**		
Trading A/c	9	**Returns Inward**	**4,000**	**1,40,000**
Trading A/c	10	**Returns Outward**		
Trading A/c	11	**Carriage Inward**	**2,000**	**5,300**
P & L A/c	12	**Carriage Outward**	**1,000**	
B/S	13	**Furniture**	**8,400**	
Trading A/c	14	**Wages**	**51,600**	
P & L A/c	15	**Salaries**	**70,000**	
Trading A/c	16	**Stock on 1.1.1990**	**80,000**	
Trading A/c	17	**Purchases**	**1,02,000**	
Trading A/c	18	**Sales**		
P & L A/c	19	**Bad debts**	**2,400**	**4,36,000**
P & L A/c	20	**Rent**	**12,200**	
B/S	21	**Cash in hand**	**50,800**	
P & L A/c	22	**General expenses**	**18,500**	
			9,68,900	**9,68,900**

Closing Stock was valued at Rs. 70,000

Solution:

Trading and Profit and Loss A/c for the year ended 31.12.1990

Dr. **Cr.**

		Rs.			Rs.
Opening Stock.		80,000	Sales	436000	
Purchases	102000		Less returns	4000	432000
Less returns	5300	96700	Closing stock		70,000
Wages.		51600			
Carriage Inward		2000			
Gross profit (Transferred to P & L A/c)		271700			
		502000			502000
Salaries		70000	Gross Profit (transferred from Trading A/c)		271700
Carriage Outward		1000			
Rent		12200			
Bad debts		2400			
General Expenses		18500			
Net Profit (Transferred to capital A/c)		167600			
		271700			271700

A revised Trial Balance (After Preparation of Trading and Profit and Loss A/c.

		Dr. Rs.	Cr. Rs.
1.	Capital		3,20,000
2	Drawings	90,000	
3	Building	3,00,000	
4	Machinery	80,000	
5	Bills Receivable	6,000	
6	Bills Payable		67,600
7	Debtors (Accounts Receivable)	90,000	
8	Creditors (Accounts Payable)		1,40,000
13.	Furniture	8,400	
21.	Cash in hand	50,800	
23	Closing Stock	70,000	
24.	Net Profit (P & L A/c credit balance)		1,67,600
		6,95,200	6,95,200

BALANCE SHEET :- Last Stage in Final Accounts:

Balance Sheet is a list of the accounts having debit balance or credit balance in the Ledger. On one side it shows the accounts that have a debit balance and on the other side the accounts that have a credit balance. The purpose of a Balance Sheet is to show a true and fair financial position of a business at a particular date. Every business prepares a balance sheet at the end of the accounting year. A Balance Sheet may be defined as:

1. "It is a statement of assets, liabilities and owner's equity (Capital) on a particular date".
2. "It is a statement of what a business concern owns and what it owes on a particular date". What it owns are called assets and what it owes are called liabilities.
3. "It is a statement which discloses total assets, total liabilities and total capital (owner's equity) of a concern on a particular date".
4. "It is a statement where all the ledger account balances which remain open after the preparation of Trading and Profit and Loss Account, find place".

Balance Sheet is so-called because it is prepared with the closing balances of ledger accounts at the end of the year. It has two sides --- assets side or left-hand side and liabilities side or right-hand side. The accounts have a debit balance are shown on the asset side and those have a credit balance are shown on the liabilities side and the total of the two sides will agree.

Assets mean all the things and properties under the ownership of the business i.e building, plant, furniture, machinery, stock, cash etc. Assets also include anything against which money or service will be received i.e. debtors, accrued income, prepaid expenses etc.

Liabilities mean our dues to others or anything against which we are to pay money or render service, i.e. creditors, outstanding expenses, amount payable to the owner of the business (capital) etc.

Assets side of the Balance Sheet indicates the different types of assets owned by a concern, while liabilities side discloses the various sources through which funds have been obtained in order to acquire those assets. Balance Sheet reveals the financial position of a concern on a particular date at a point of time, so it is also called "*Position Statement*". It is prepared on the last day of an accounting year and discloses the financial position of the business only for that day. It is important to note that the financial position of a concern for the whole year cannot be determined through the Balance Sheet because financial position is ever changing. That is why the heading of Balance Sheet is given as under:

Balance Sheet as at 31st December, 1990

(If accounting year ends on 31. 12.1990)

Features:- Balance Sheet has the following features:

1. It is the last stage of Final Accounts.
2. It is prepared on the last day of an accounting year.
3. It is not an account under the Double Entry System--it is a statement only.
4. It has two sides -- left-hand side known as Asset side and right-hand side known as liabilities side.
5. The totals of both sides are always equal.
6. The balances of all Asset accounts and liability accounts are shown in it. No expense accounts and revenue accounts are shown here.
7. It discloses the financial condition and solvency of the business.
8. It is prepared after the preparation of Trading and Profit and Loss A/c because the net profit or net loss of a concern is included in it through Capital A/c.

METHOD OF PREPARATION

All the information necessary for preparation of Balance Sheet is available from the Trial Balance and from some other ledger accounts. From the Trial Balance, we have already transferred the accounts relating to expenses and revenue to Trading and Profit and Loss Account. Now, what is left in the Trial Balance? Trial Balance, now, contains only the accounts of Assets, liabilities and capital. All assets have debit balances and all liabilities and capital have credit balances. The assets are shown on the assets side of the Balance Sheet and liabilities and capital are shown on the liabilities side of the Balance Sheet after arranging them properly.

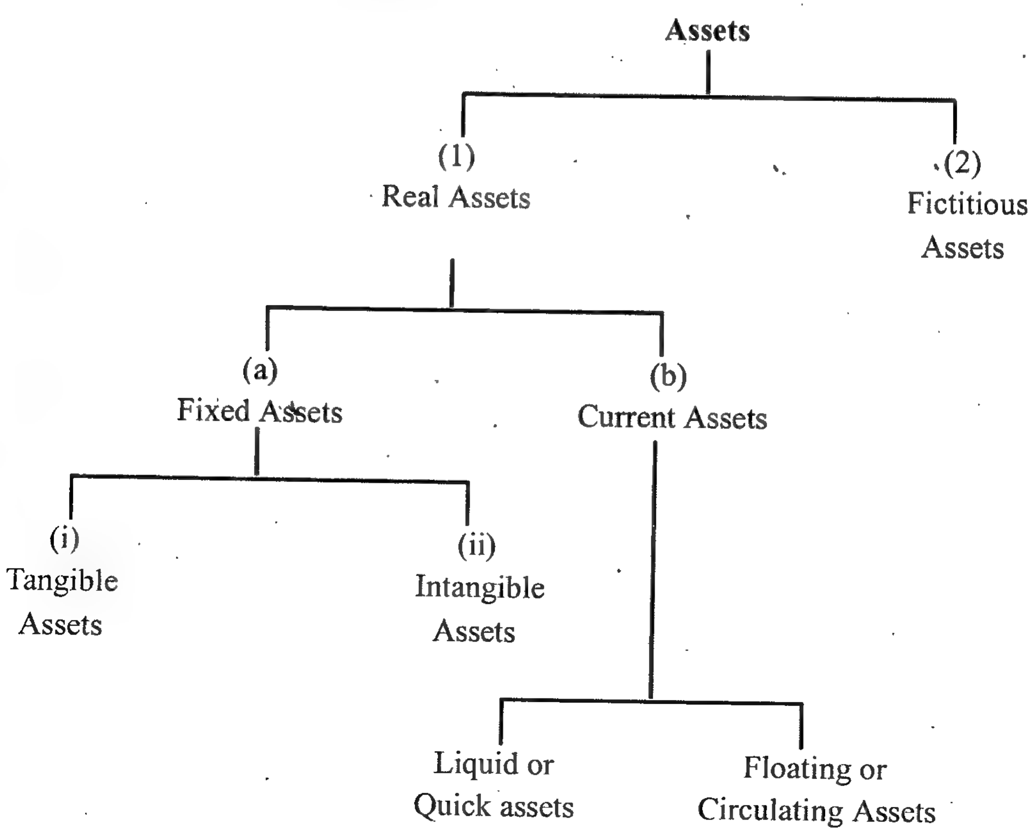
As the Balance Sheet is prepared on the last day of an accounting year, so its heading and format will be.

NAME OF BUSINESS
Balance Sheet
as at 31st December, 1991
(If accounting year ends on 31.12.1991)

Assets	Rs.	Liabilities and Capital	Rs.

CLASSIFICATION OF ASSETS:

Assets may be classified as follows:



1. **REAL ASSETS:** Assets which have some market value are called real assets, e.g. Building, Machinery, Stock, Debtors, Cash, Goodwill etc. Real assets may be divided into two according to their permanence.

(a) ***Fixed Assets:-*** Assets which have long life and which are bought for use for a long period of time are called 'Fixed Assets'. These are not bought for selling purposes, e.g. Land, Building, Plant Machinery, Furniture etc. Fixed assets are again sub-divided into two.

(i) ***Tangible Assets:*** Assets which have physical existence and which can be seen, touched and felt are called 'Tangible Assets', e.g. Building, Plant, Machinery, Furniture etc.

(ii) ***Intangible Assets:*** Assets which have no physical existence and which cannot be seen, touched or felt are called 'Intangible Assets', e.g. Goodwill, Patent Right, Trade-mark etc.

(b) ***Current Assets:*** Assets which are short-lived and which can be converted into cash quickly to meet short-term liabilities are called 'Current Assets', e.g. Stock, Debtors, Cash etc. Such assets change their form repeatedly and so, they are also known as *Circulating or floating Assets*. For example, on purchase of goods cash is converted into stock and on sale of goods, stock is converted into debtors, on collection from debtors, debtors take the form of cash etc.

Out of the current assets those which can be converted into cash very quickly or which are already in the form of cash are called '*Liquid or Quick Assets*', e.g. debtors, cash in hand, cash at bank etc.

2. **FICTITIOUS ASSETS:** Assets which have no market value are called '*fictitious assets*', e.g. Preliminary expenses, Loss on issue of shares or debentures etc. They also known as 'nominal assets'.

Beside these, there is another type of assets whose value gradually reduces on account of use and finally exhausts completely. This type of assets is called "*Wasting Assets*", e.g. Mine, Forest etc.

CLASSIFICATION OF LIABILITIES:

Liabilities may be classified as follows:

- Liabilities
  - Internal Liabilities (Capital or Owner's Equity)
  - External Liabilities
    - Fixed or Long-Term Liabilities
    - Current or short-Term Liabilities
      - Deferred Liabilities
      - Liquid or Quick Liabilities

1. *Internal Liabilities:-* The total amount of debts payable by a business to its owner is called 'Internal Liability', e.g. Owner's equity (capital), Reserves etc. From practical viewpoint, internal liabilities should not be regarded as liabilities, since there is no question of meeting such liabilities as long as the business continues.

2. *External Liabilities:-* All debts payable by a business to the outsiders (other than the owner) are called 'External Liabilities', e.g. Creditors, Debentures, Bills Payable, Bank overdraft etc. External liabilities are further divided into two.

   (a) ***Fixed or Long -Term Liabilities:-*** The liabilities which are repayable after a long period of time are called 'Fixed or Long-Term Liabilities', e.g. Debentures, Loan on mortgage etc.

   (b) **Current or Short-Term Liabilities:-** The debts which are repayable within a short period of time are called 'Current or Short-Term Liabilities', e.g. Creditors, Bills Payable, Bank overdraft etc. Current liabilities may again be divided into two:

      (i) ***Deferred Liabilities:-*** Debts which are repayable in the course of less than one year but more than one month, are called *"Deferred Liabilities", e.g.* Short-Term Loan etc.

      (ii) ***Liquid or Quick Liabilities:-*** Debts which are repayable in the course of a month are called *"Liquid or Quick Liabilities",* e.g. Bank overdraft, outstanding expenses, creditors etc.

Besides the above, there is another type of liability which is known as ***"Contingent Liability".*** It is one which is not a liability at present, but which mav or may not become a liability in future. It depends upon certain future event. For example, suppose, the buyer of goods filed a suit in the court against the seller claiming damage of Rs.10,000 for breach of contract. This will be regarded as a contingent liability to the seller until the receipt of court's order. To the buyer, this is a *"Contingent Asset".* Both contingent liability and contingent asset are not recorded in the Balance Sheet. They are generally mentioned in the Balance Sheet as a note.

GROUPING AND MARSHALING OF ASSETS & LIABILITIES IN BALANCE SHEET

As we have discussed that the main purpose of Balance Sheet is to disclose a true and fair financial position of a business on a particular date. So, the assets and liabilities must be shown in such a manner that the financial position of the business can be assessed through it easily and quickly. Thus an arrangement is made in which assets and liabilities are shown in the Balance Sheet. Such an arrangement is called *"Marshaling of Assets and Liabilities".*

There are three methods of marshaling:

1. Permanency Preference Method.
2. Liquidity Preference Method.
3. Mixed Method.

THE METHODS ARE DISCUSSED BELOW:

1. ***Permanency Preference Method:-*** Under this method the assets and liabilities are shown in Balance Sheet in the order of their permanence. In other words, the more permanent the assets and liabilities, the earlier are they shown.

2. ***Liquidity Preference Method:-*** Under this method assets and liabilities are shown in order of their liquidity. The more liquid the assets (Which can be quickly converte into cash), the earlier are they shown. The sooner the liabilities are to be paid off, the earlier are they shown.

3. *Mixed Method:-* Under this method assets are shown in the order of permanence and liabilities are shown in order of liquidity.

The first method is adopted by joint stock companies and under this method the Balance Sheet will take the following form:-

Balance Sheet as at..........

Assets	Rs.	Liabilities	Rs.
Fixed Assets:		**Fixed Liabilities:**	
Good will		Capital	
Patent		Reserves	
Land		Long - Term Loan	
Building		**Current Liabilities:**	
Plant & Machinery		Sundry Creditors	
Furniture & Fixtures		Bills Payable	
Current Assets:		Bank Overdraft	
Investment		Outstanding Expenses	
Stock			
Sundry Debtors			
Bills Receivable			
Prepaid Expenses			
Liquid Assets:			
Cash at Bank			
Cash in hand			

The second method is adopted in sole Proprietorship and Partnership business. Under this method, the form of Balance Sheet is:

Balance Sheet as at..............

Exactly reverse of the first method.

Assets	Rs.	Liabilities	Rs.
Liquid Assets		Current Liabilities	
Current Assets		Fixed Liabilities	
Fixed Assets			

The third method is adopted by the banks and insurance companies etc.

ILLUSTRATION NO. 6 54

A revised Trial Balance of illustration No. 5 is given below. From this revised Trial Balance prepare a Balance Sheet as at 31st December, 1990.

REVISED TRIAL BALANCE

		Dr. Rs.	Cr. Rs.
1.	Capital		3,20,000
2.	Drawings	90,000	
3.	Building	3,00,000	
4.	Machinery	80,000	
5.	Bills Receivable	6,000	
6.	Bills Payable		67,600
7.	Debtors (A/R)	90,000	
8.	Creditors (A/P)		1,40,000
13.	Furniture	8,400	
21.	Cash in hand	50,800	
23.	Closing Stock	70,000	
24.	Net Profit		1,67,600
		6,95,200	6,95,200

Solution:

Balance Sheet
as at 31st December, 1990

Assets	Rs.	Liabilities		Rs.
Liquid Assets:		**Current Liabilities:**		
Cash in hand	50,800	Bills Payable		67,600
Current Assets:		Creditors		1,40,000
Bills Receivable	6,000	**Fixed and Long-Term Liabilities:**		
Debtors (A/R)	90,000	Capital	3,20,000	
Closing Stock	70,000	+ Net Profit	1,67,600	
Fixed Assets:			4,87,600	
Furniture	8,400	- Drawings	90,000	3,97,600
Machinery	80,000			
Building	3,00,000			
	6,05,200			6,05,200

NOTE:-

Although, Drawings A/c has a debit balance, but it is shown on the liability side of the Balance Sheet as a deduction from capital, because it is not an asset of the business.

It may also be noted that all accounts (from the revised Trial Balance), having a debit balance (except Drawing A/c) are transferred on the asset side of Balance Sheet and all accounts having a credit balance are transferred on the liability side of the Balance Sheet.

Difference between Trial Balance and Balance Sheet:

Trial Balance	Balance Sheet
1. It is prepared to verify the arithmetical accuracy of books of accounts.	1. It is prepared to disclose the true financial position of the business.
2. It is prepared with balances of all the ledger accounts.	2. It is prepared with the balances of assets and liabilities accounts.
3. It is not a part of final accounts.	3. It is an important part of Final Accounts.
4. It is prepared before the preparation of Final Account.	4. It is prepared after the preparation of Trading and Profit and Loss A/c.
5. It may be prepared a number of times in an accounting year.	5. It is generally prepared once only at the end of accounting year.
6. Generally, it includes opening stock but not closing stock.	6. It always includes closing stock but not opening stock.
7. There is no rule for arranging the ledger balances in it.	7. Assets and liabilities must be shown in it according to the rules of marshaling.
8. It is not required to be filed to anybody.	8. It must be filed with the Registrar of companies if the business is a company.
9. Auditor need not to sign it.	9. Auditor must sign it.

ILLUSTRATION NO. 7 SL

The following Trial Balance is taken out from the books of Rashid & Sons as on 31st December, 1990.

		Dr. Rs.	Cr. Rs.
B/S	**Plant & Machinery**	**1,00,000**	
Trading A/c	**Opening Stock**	**60,000**	
//	**Purchases**	**1,60,000**	
B/S	**Building**	**1,70,000**	
Trading A/c	**Carriage Inward**	**3,400**	
P&L A/c	**Carriage Outward**	**5,000**	
Trading A/c	**Wages**	**32,000**	
B/S	**Sundry Debtors**	**1,00,000**	
P&L A/c	**Salaries**	**24,000**	
B/S	**Furniture**	**36,000**	
P&L A/c	**Trade Expenses**	**12,000**	
Trading A/c	**Discount on Sales**	**1,900**	
P&L A/c	**Advertisement**	**5,000**	
P&L A/c	**Bad Debts**	**1,800**	
B/S	**Drawings**	**10,000**	
B/S	**Bills Receivable**	**50,000**	
P&L A/c	**Insurance**	**4,400**	
B/S	**Bank Balances**	**20,000**	
Trading A/c	**Sales**		**4,80,000**
P&L A/c	**Interest Received**		**2,000**
B/S	**Sundry Creditors**		**40,000**
B/S	**Bank Loan**		**1,00,000**
Trading A/c	**Discount on Purchases**		**2,000**
B/S	**Capital**		**1,71,500**
		7,95,500	**7,95,500**

Req: Prepare the Trading and Profit and Loss A/c of the business for the year ended 31.12.1990 and a Balance Sheet as at that date: Closing stock is valued at Rs. 90,000.

Solution:

Rashid & Sons
Trading and Profit and Loss Account
for the year ended 31st December, 1990

Dr. Cr.

		Rs.			Rs.
Opening Stock		60,000	Sales	4,80,000	
Purchases	1,60,000		Less Discount		
Less Discount			on Sales	1,900	4,78,100
On Purchases:	2,000	1,58,000	Closing Stock		90,000
Carriage Inward		3,400			
Wages		32,000			
Gross Profit (transferred to P & L A/c)		3,14,700			
		5,68,100			5,68,100
Carriage Outward		5,000	Gross Profit b/d		3,14,700
Salaries		24,000	Interest Received		2,000
Trade Expenses		12,000			
Advertisement		5,000			
Bad Debts		1,800			
Insurance		4,400			
Net Profit (transferred to capital)		2,64,500			
		3,16,700			3,16,700

NOTE: Discount on purchases and discount on sales are deducted from purchases and sales respectively. They may be shown on the credit and debit side of Profit and Loss A/c respectively and it will not affect the net profit of the business.

Rashid & Sons
Balance Sheet
as at 31.12.1990

Assets	Rs.	Liabilities		Rs.
Current Assets:		**Current Liabilities:**		
Bank Balance	20,000	Sundry Creditors		40,000
Bills Receivable	50,000	Bank Loan		1,00,000
Sundry Debtors	100,000	**Fixed and Long-Term**		
Closing Stock	90,000	**Liabilities:**		
Fixed Assets:		Capital	1,71,500	
Furniture	36,000	+ Net Profit	2,64,500	
Plant & Machinery	1,00,000		4,36,000	
Building	1,70,000	- Drawings	10,000	4,26,000
	5,66,000			5,66,000

QUESTIONS

1. What are Final Accounts and why are they prepared?
2. What do you mean by Trading A/c? How is it prepared? What accounting information do we get from it?
3. What do you understand by Gross Profit? Briefly state its importance.
4. What do you understand by a Profit and Loss A/c? Explain the difference between Trading A/c and Profit and Loss A/c.
5. What do you mean by a Balance Sheet?
6. What is Balance Sheet? What is the information available from it?
7. What do you mean by "Assets" and "Liabilities"? How are these classified?
8. What is marshaling of Assets and liabilities in a Balance Sheet?
9. Describe various methods of marshaling a Balance Sheet.
10. Explain the difference between a Balance Sheet and a Trial Balance.

PROBLEMS

1. 5L **Prepare a Trading A/c of Asif & Sons for the year ended 31st December, 1990 from the following information:**

	Rs.		Rs
Purchases	26,231	Sales Returns	620
Rent	300	Purchases Returns	201
Furniture	930	Carriage Inward	130
Salary to Staff	1,626	Carriage Outward	65
Wages	162	Opening Stock	1,635
Sales	39,376	Closing Stock	1,827

Ans: *{G. P. Rs. 12,626}*

2. 5L **Prepare from the following information supplied by a trader, a Trading A/c for the year ended 31st March, 1990:**

	Rs.		Rs
Cash in Hand	7,320	Carriage on Goods	1,200
Opening Stock	10,560	Carriage on Goods Sold	1,600
Closing Stock	23,800	Railway Freight	1,000
Credit Purchases	40,000	Wages	10,240
Cash Purchases	10,720	Salaries	26,000
Purchases Returns	5,280	Trade Charges	7,200
Cash Sales	24,000	Discount on Purchases	1,400
Credit Sales	86,240	Discount on Sales	400
Sales Returns	1,960		

Ans. *{G. P. Rs. 64,640}*

3. The following Trial Balance was extracted from the books of Salman on 31.12.1990.

	Dr. Rs.		Cr. Rs.
Opening Stock	1,16,000	Capital	2,00,000
Building	2,00,000	Sales	8,42,000
Purchases	5,72,000	Sundry Creditors	2,40,000
Sundry Debtors	2,78,000	Purchase Returns	42,000
Sales Returns	72,000		
Carriage Inward	12,000		
Carriage Outward	16,000		
Salaries	32,000		
Furniture	16,000		
Cash in Hand	10,000		
	13,24,000		13,24,000

Closing Stock was valued at Rs. 1,62,000.

Req: (a) Prepare a Trading A/c for the year ended 31.12.1990.

(b) Prepare a revised Trial Balance after preparation of Trading A/c.

Ans: *{(a) G.P. Rs. 2,74,000 (b) Revised T.B. Total Rs. 7,14,000}*

4. Prepare the Profit and Loss A/c of M. Naeem for the year ended 30.6.1990 from the following information:

	Rs.		Rs.
Gross Profit	19,940	Discount Received	100
Salaries	6,450	Interest Received	640
Rent & Taxes	1,300	Depreciation	1,120
General Expenses	3,950	Commission Paid	200
Discount Allowed	580	Bank Charges	20
		Bad Debts	260

Ans: *{N.P. Rs. 6,800}*

5. From the information given below, prepare the Profit and Loss A/c of Javed & Co. for the year ended 31.12.1990.

	Rs.		Rs.
Trading A/c (credit balance)	27,158	General Expenses	1,920
Salaries to Staff	9,580	Bad Debts	240
Carriage Outward	300	Bank charges	50
Rent, Rates & Taxes	1,400	Dividend Received	350
Selling Commission	268		

Ans: *{N.P. Rs. 13,750.}*

6. SL From the following Trial Balance prepare a Profit and Loss Account for the year ended 31st December, 1990. Also prepare a revised Trial Balance after preparation of Profit and Loss A/c.

	Dr. Rs.	Cr. Rs.
Capital		75,200
Building	60,000	
Furniture	12,000	
Investment in Shares	16,000	
Sundry Debtors (A/R)	24,000	
Sundry Creditors (A/P)		36,000
Closing Stock	4,000	
Gross Profit (credit balance)		32,000
Salaries	10,000	
Insurance	2,400	
Printing Charges	7,000	
Advertisement	8,000	
Discount allowed	1,200	
Discount Received		1,000
Bad Debts	500	
Interest Received		900
	1,45,100	1,45,100

Ans: *{N.P. Rs. 4,800, Revised T.B. Total Rs. 1,16,000}*

7. The following Trial Balance was extracted from the books of Zubair on 31.12.1990. Prepare a Trading and Profit and Loss A/c for the year ended 31st December, 1990, and a Balance Sheet as at that date:.

SL

	Dr. Rs.		Cr. Rs.
Opening Stock	4,000	Capital	90,000
Purchases	83,330	Bills Payable	2,000
Carriage Inward	2,680	Sundry Creditors	51,260
Wages	6,900	Purchases Returns	2,000
Sales Returns	400	Loan	16,000
Carriage Outward	790	Discount Received	300
General Expenses	640	Sales	150,000
Printing Charges	440		
Interest Paid	380		
Cash in Hand	30,000		
Cash at Bank	36,000		
Sundry Debtors	56,000		
Machinery	22,000		
Furniture	6,000		
Building	56,000		
Drawings	6,000		
	3,11,560		3,11,560

Closing Stock was valued at Rs. 3,000.

Ans: *{G.P. Rs. 57,690, N.P. Rs. 55,740, Balance Sheet Rs. 2,09,000}*

8. **The following balances have been taken from the books of a trader on 31.3.1991:**

SL

	Rs.		Rs.
Cash at Bank	60,000	Salaries	22,200
Machinery	185,000	Discount Allowed	4,000
Building	375,000	Opening Stock	3,30,000
Debtors	140,000	Capital	7,00,000
Trade Expenses	16,000	Bills Payable	1,00,000
Rent Rates	74,200	Sales	12,70,000
Import Duty	3,800	Purchases	9,37,000
Drawings	13,000	Wages	50,000
Electric Charges	17,000	Cash in Hand	36,000
Returns Inward	9,000	Creditors	2,00,000
Returns Outward	2,200		

Closing Stock has been valued at Rs. 3,64,200.

Req: **Prepare a Trading and Profit and Loss A/c for the year ended 31.3.1991, and a Balance Sheet as at 31.3.1991.**

Ans: *{G.P. Rs. 3,06,600, N.P. Rs. 1,73,200, Balance Sheet total Rs. 11,60,200}*

9. **From the following Trial Balance extracted from the books of Rehman & Sons prepare a Trading and Profit and Loss Account for the year ended 31.12.1991 and a Balance Sheet as at that date:-**

SL

	Dr. Balances Rs.	Cr. Balances Rs.
Sales		2,04,000
Capital		1,20,000
Bank Overdraft		1,03,560
Sundry Creditors		1,20,000
Stock. 1.1.1991	60,400	
Purchases	2,31,600	
Sundry Debtors	109,660	
Returns Inward	3,640	
General Expenses	6,980	
Plant	22,620	
Wages & Salaries	16,740	
Building	50,000	
Cash in Hand	680	
Cash at Bank	8,720	
Drawings	16,960	
Motive Power	2,300	
Dock & Clearing Charges	1,300	
Coal, Gas, Water	1,700	
Salaries	9,820	
Interest on Overdraft	4,440	
	5,47,560	5,47,560

Closing stock was valued at Rs. 40,000.

Ans: *{Gross Loss Rs. 73,680, Net Loss Rs. 94,920, Balance Sheet Total Rs. 2,31,680}*

CHAPTER - 11

ADJUSTMENTS AND THEIR EFFECT ON FINAL ACCOUNTS

ADJUSTMENTS AND THEIR EFFECT ON FINAL ACCOUNTS

THE TWO SYSTEMS OF ASCERTAINING PROFIT OR LOSS :

It has been discussed that every business concern ascertains profit or loss of the business at the end of the year through Final Accounts. Gross profit or loss of the business is ascertained through Trading A/c and net profit or loss is determined through Profit and Loss Account. There are two systems of ascertaining profit or loss of the business:

1. Cash System.
2. Accrual or Mercantile System.

These two systems are discussed below in details :

1. CASH SYSTEM:

Under this system profit or loss of the business is determined by comparing (matching) only the items of revenue which have been received in cash with the items of expenses which have been paid in cash during an accounting period. The items of revenue which the business has earned (credit sales, interest receivable etc.) but have not been received in cash will not be considered, while determining profit or loss of the business. Similarly, the items of expenses which are incurred but have not been paid in cash (credit purchases, wages payable, salaries payable etc.) will not be considered. Thus, **"the system under which the annual result (profit or loss) of the concern is ascertained on the basis of only the items of revenue received in cash and the items of expenses paid in cash whether they relate to the current accounting year or not — is called cash system".**

Generally this system is not followed by businessmen. Professional persons or bodies like lawyers, doctors, chartered accountant's firms etc. maintain accounts under this system.

ACCRUAL OR MERCANTILE SYSTEM:

All large business concerns follow this system.

Under this system the profit or loss of a business is ascertained by comparing all items of revenue (whether received in cash or not) with all items of expenses (whether paid in cash or not) relating to the current accounting period. In other words, an item of revenue, whether received in cash or not, and an item of expenditure, whether paid in cash or not, must be taken into consideration, if they relate to the current accounting period. Thus "**the system under which all items of revenue and expenses relating to the current accounting period -- whether received / paid in cash or not — are taken into consideration while determining the profit or loss of the business, is called Accrual or Mercantile System.**" Suppose, if our current accounting year is 1990, then.

$$\left\{\begin{array}{c}\text{all revenue items}\\ \text{relating to 1990}\\ \text{(received + receivable)}\end{array}\right\} \text{ Vs } \left\{\begin{array}{c}\text{all items of expenses}\\ \text{relating to 1990}\\ \text{(paid + payable)}\end{array}\right\}$$

Generally, businessmen ascertain profit or loss of their businesses under this system.

ADJUSTMENTS AND THEIR NEED:

In the previous chapter, we prepared Final Accounts on the basis of the Trial Balance provided to us. But, in practice, generally, the Trial Balance does not give us complete information. There are some accounts in the ledger which do not show their true or correct balances and they need some adjustments to be made in them. As we know, the Final Accounts (Financial Statements) must be as complete and accurate as possible. The Balance Sheet must contain all the assets and liabilities at the close of the business on the last day of the period. The Trading and Profit and Loss Account (Income statement) must contain all the revenue and expenses relating to the current accounting period but must not contain any revenue or expense relating to the previous period or the following period. So, before we prepare Final Accounts at the end of the accounting period, **we need to adjust some of the account balances in the Ledger.** These accounts are adjusted by passing adjusting entries. For example, suppose at the end of the accounting year, 1990, the balance of wages A/c in the Trial Balance is Rs. 3,000. Now it is found that there are some workers to whom wages of Rs. 700 have not been paid (services have been received) till the end of the year, 1990.

It means wages A/c is not showing true balance and needs some adjustment. Now an entry will be passed to adjust the wages A/c , that will be;

	Rs.	Rs.
Wages Account ....Dr.	700	
Wages Payable Account		700

(To record wages that have not been paid).

Look at the wages A/c before and after it is adjusted;

Dr. Wages A/c

Balance b/d	3,000	

{Before adjustment}

Dr. Wages A/c

Balance b/d	3,000	
Wages payable	700	

{After adjustment showing correct balance}

Now, it is clear that the true balance of wages A/c is Rs. 3,700 and not Rs. 3,000. What would be the effect on the Trading and profit and loss Account for 1990 if the above adjustment was not made? The expense would be understated by Rs. 700 and consequently the net profit would be overstated by Rs. 700.

MAIN TYPES OF ADJUSTMENTS :

1. Accrued Expenses or outstanding Expenses or Expenses payable.
2. Prepaid Expenses or unexpired Expenses or Expenses paid in advance.
3. Accrued Revenue or Revenue Receivable.
4. Unearned Revenue or Revenue Received in advance.
5. Depreciation of assets.
6. Provision for bad debts.

7. Provision for discounts.
8. Interest on capital.
9. Interest on drawings.

Adjusting entries are made at the end of an accounting period to update and correct the information shown in the accounts.

Before beginning a detailed discussion of the above mentioned adjustments the students are advised to remember the following two points:

1. **The purpose of adjustments is to prepare a perfectly accurate set of Final Accounts for the accounting period under review, and a perfectly true Balance Sheet as at the present date.**
2. **Every adjusting entry is posted in two ledger accounts. Usually, one side (aspect) of an adjusting entry involves a revenue or expense account while the other side (aspect) involves an asset or liability account. In other words, every adjusting entry will affect both the Trading and profit and loss A/c (Income statement) and Balance Sheet.**

1. ACCRUED EXPENSES OR OUTSTANDING EXPENSES OR EXPENSES PAYABLE :

The expenses that have been incurred during the current year (the services have been received during the current year) but have not been paid till the end of the current accounting year, are known as **"outstanding or Accrued expenses"**. For example, suppose salaries Rs. 33,000 have been paid up to the month of November, 1990 (for 11 months) and have been recorded but salaries Rs. 3,000 for the month of December have not been paid and so have not been recorded (although the services have been received from the employees). It means salaries A/c is showing a debit balance of Rs. 33,000 instead of Rs. 36,000. This will be treated as an expense for the year, 1990 and, therefore, on 31st December, 1990, the following adjusting entry will be passed,

Increase in expense and increase in liability.

		Rs.	Rs.
Salaries Account	Dr.	3,000	
Outstanding Salaries Account			3,000

NOTE: In the beginning of the next year, a reverse entry will be passed to cancel the effect of adjusting entry:

It may be noted that Salary A/c and outstanding Salaries A/c are two different accounts. Debit to Salaries A/c indicates ``**increase in expense (from Rs. 33,000 to Rs. 36,000)** and credit to outstanding salaries A/c indicates increase in a liability (as salaries are still payable). Now the two accounts will look like this,

Salaries A/c

	Rs.	
Balance b/d	33,000	
Outstanding Salaries A/c	3,000	

(an expense A/c)

Outstanding Salaries A/c

	Salaries A/c Rs. 3,000

(a liability A/c)

This adjustment will have double effect on Final Accounts. **A sum of Rs. 3000 will be added the amount of salaries and total amount (33000 + 3000) Rs. 36000 will be debited to Profit and Loss A/c and the sum of Rs. 3000 will also be shown on the liability side of Balance sheet as "outstanding salaries"** Thus,

Outstanding Expenses

Added to the Concerned Expense A/c in Trading and P and L A/c

Shown on the liability side of Balance Sheet.

Look at the Profit and Loss A/c and Balance Sheet given below;

Profit and Loss A/c

		Rs.	
Salaries	33,000		
+ outstanding	3,000	36,000	

Balance Sheet as at 31.12.90

Assets	Liabilities	Rs.
	Outstanding salaries	3,000

2. **PREPAID EXPENSES OR UNEXPIRED EXPENSES OR EXPENSES PAID IN ADVANCE:**

The expenses which have been paid during the current year but the services or benefit against them have not been received till the end of current year (services will be received in next year) are known as "**Prepaid expenses**". In other words, the expenses of the next year paid in current year are regarded as prepaid expenses for the current year. For example, suppose, on 1st January, 1990, we acquired a building on rental basis. The rent of the building is Rs. 1,000 per month. We paid rent for 15 months Rs. 15,000 (1,000 x 15). At the close of the current year (on 31st December, 1,990), the building has been used for 12 months. So rent of Rs. 12,000 (12 x 1,000) will be regarded as an expense of the current year and rent of Rs. 3,000 (3 x 1,000) will be regarded as prepaid rent on 31st December and its benefit will be received in the next year. Prepaid rent is regarded as an asset because the benefit is to be received in the next year.

METHODS OF DEALING WITH THE PREPAID EXPENSES:

1. Prepaid expenses initially recorded as an expense.
2. Prepaid expenses initially recorded as an asset :-

1. Under this method, when expenses are paid, we debit the concerned expense account and credit cash account. At the end of the current year, the portion of expense which relate to the next year is transferred to "Prepaid expense account" by debiting prepaid expense account (an asset) and crediting expense account.

In the above example, when rent is paid for 15 months Rs. 15,000, the following entry will be passed.

		Rs.	Rs.
Rent Account	Dr.	15,000	
Cash Account			15,000

When a portion of the rent Rs. 3,000 which relates to next year is transferred to prepaid rent account, the following adjusting will be passed,

		Rs.	Rs.
Prepaid Rent Account	Dr.	3,000	
Rent Account			3,000

As a result the Rent A/c will show a debit balance of Rs. 12,000 (15,000 - 3,000) and Prepaid rent A/c will show a debit balance of Rs. 3,000. So,

Double effect on Final Accounts.

Prepaid expenses

Deducted from the concerned expense in Profit and Loss A/c

Shown on the asset side of Balance Sheet as "Prepaid expenses".

Now look at the Profit and Loss A/c and Balance Sheet given below;

Profit and Loss A/c

		Rs.	
Rent	15,000		
- Prepaid	3,000	12,000	

BALANCE SHEET

Assets	Rs.	Liabilities	Rs.
Prepaid rent	3000		

2. Under this method, when an expense is paid in advance, it is debited to asset ``Prepaid expense" account and credited to cash account. At the end of the current year, the portion of expense against which the services have been received is transferred to concerned expense account.

Thus, when rent is paid in the above example, the entry will be;

		Rs.	Rs.
Prepaid Rent Account	Dr.	15,000	
Cash Account			15,000

At the end of the current year the following adjusting entry will be passed,

		Rs.	Rs.
Rent Account	Dr.	12,000	
Prepaid Rent Account			12,000

As a result the Prepaid rent A/c is showing a debit balance of Rs. 3,000 (15,000 - 12,000) which will be shown on the asset side of Balance sheet and Rent A/c is showing a debit balance of Rs. 12,000 which will be shown on the debit side of Profit and Loss A/c.

It may be noted that under both the methods the result is the same, Rent A/c shows a debit balance of Rs. 12,000 and Prepaid Rent A/c shows a debit balance of Rs. 3,000.

ILLUSTRATION NO. 1

Two sources of information, the Trial Balance and adjustments given outside the Trial Balance.

The Trial Balance of a trader as on 31.12.1990 is given below:

	Debit Rs.		Credit Rs.
Opening stock	60,000	Bills Payable	10,000
Sundry Debtors	80,000	Returns outward	2400
Furniture	20,000	Capital	140,000
Plant	100,000	Interest received	1000
Purchases	340,000	Sales	462000
Bills Receivable	22000	Commission received	400
Carriage Inward	2600	Creditors	80,000
Carriage Outward	1800		
Insurance paid	1400		
Returns Inward	4000		
Salaries	24000		
Wages	20000		
Cash at Bank	18000		
Cash in hand	2000		
	695800		695800

Prepare a Trading and Profit & Loss A/c for the year ended 31.12.1990 and Balance Sheet as at that date after taking into consideration the following 'adjustments,'

1. **Closing stock valued at Rs. 1,00,000.**
2. **Outstanding salaries Rs. 6,000 and outstanding wages Rs. 1,000.**
3. **Insurance included a sum of Rs. 350 relating to the next year, 1991.**

Solution:

Trading and Profit and Loss A/c for the year ended 31.12.90

Dr. Cr.

	Rs.		Rs.
Opening Stock	60,000	Sales : 462000	
Purchases : 340,000		Less returns 4000	458000
Less returns 2400	337600		
Carriage Inward	2600	Closing stock	100,000
Wages 20,000			
+ outstanding wages 1000	21000		
Gross Profit (transferred to P & L A/c)	136800		
	558000		558000
Carriage outward	1800	Gross Profit b/d	136800
Insurance : 1400		Interest received.	1000
Less Prepaid. 350	1050	Commission received	400
Salaries. 24000			
+ outstanding salaries 6000	30,000		
Net Profit (transferred to capital A/c)	105350		
	138200		138200

Outstanding wages added to wages.

(1) Insurance prepaid deducted from Insurance.

(2) Outstanding salaries added to salaries.

Balance Sheet as at 31st December, 1990

Assets	Rs.	Liabilities	Rs.
Current Assets		**Current Liabilities**	
Cash in hand	2000	Bills Payable	10,000
Cash at Bank	18000	Creditors	80,000
Sundry Debtors	80,000	Outstanding wages	1000
Bills Receivable	22000	Outstanding Salaries	6000
Closing Stock	100,000	**Fixed & Long Term**	
Prepaid Insurance	350	**Liabilities:**	
Fixed Assets:		Capital 140,000	
Furniture	20,000	+ net profit 105350	245350
Plant	100,000		
	342350		342350

It may be noted that the Final Accounts have not been prepared only from Trial Balance. Now the sources of information are: (1) Trial Balance and (2) adjustments given out of the Trial Balance.

3. ACCRUED REVENUE OR REVENUE RECEIVABLE :

There may be a revenue which we have earned or which has become due in the current year but has not been received in cash within the current year ____ it will be received next year. Such a revenue is known as **"Accrued revenue".** For example, suppose, we deposited Rs. 100,000 into the bank at 10% p.a rate of interest on 1st January, 1990. On 30th June, 1990, the bank paid us Rs. 5000 as interest for six months and we passed the following entry,

	Rs.	Rs.
Bank / Cash Account ....Dr.	5000	
Interest Account		5000

On 31st December, 1990, the total interest due from bank is Rs. 10,000 (100,000 x 10/100), out of which we have already received Rs. 5000 as interest. It means interest of Rs. 5000 is still due from the bank and this is known as **"accrued interest"** So on 31st December, 1990, an adjusting entry will be passed,

	Rs.	Rs.
Accrued Interest Account ....Dr.	5000	
Interest Account		5000

Accrued interest A/c is debited with Rs. 5000, which shows increase in asset and Interest A/c is credited which shows increase in interest (revenue) from 5000 to 10,000. Accrued Interest A/c will be shown **on the asset side of the Balance Sheet and a sum of Rs. 5000 will be added to the amount of interest actually received and the total (5000 + 5000) will be shown on the credit side of Profit and Loss A/c.**

Accrued Revenue

Added to the concerned revenue in P & L A/c (credit side).

Shown on the asset side of Balance Sheet as "Accrued revenue".

The above mentioned example will be shown in Profit and Loss A/c and Balance Sheet as follows,

Profit and Loss A/c

			Rs.
		Interest received 5,000	
		+ Accrued interest: 5,000	10,000

Balance Sheet as at 31.12.90

Assets	Rs.	Liabilities	Rs.
Accrued interest	5,000		

4. UNEARNED REVENUE OR REVENUE RECEIVED IN ADVANCE :

When payment is received for services prior to the time that they are performed or rendered, the business receiving the payment is said to have unearned revenue. In other words, the revenue that has not become due, but has received in cash in the current year is known as **"Unearned Revenue".** e.g. rent received in advance, commission received in advance, interest received in advance etc.

Unearned revenue or revenue received in advance is an obligation (liability) to provide services in near future for which payment has already been received. For example, suppose, Mr. Salman is a commission agent and has received Rs. 6,000 as a commission from his clients during the current year, 1990. One half of the commission received is in respect of services to be provided next year. It means the revenue earned during the current year is Rs. 3,000 only and commission of Rs. 3,000 relates to next year which is unearned commission for the current year, 1990. It is now liability (obligation) of Mr. Salman to provide services to his clients in the next year.

Two Methods of dealing with unearned Revenue:

(1) Amount of revenue initially recorded as a revenue.

(2) Amount of revenue initially recorded as a liability (unearned revenue).

1. Under this method amount received is initially recorded as a revenue by debiting cash account and crediting the concerned revenue account. At the end of the accounting period, the portion of revenue against which the services have not been provided is transferred to unearned revenue account by debiting the concerned revenue account and crediting unearned revenue account :

In the above mentioned example when commission is received, the following entry will be passed,

Increase in cash (asset) and increase in revenue (commission).

	Rs.	Rs.
Cash Account ....Dr.	6,000	
Commission Account		6,000

At the end of the accounting period services have been provided equal to Rs. 3,000. So the remaining commission (6,000 - 3000) will be transferred to unearned commission and the following entry will be passed,

Decrease in revenue and increase in liability.

	Rs.	Rs.
Commission Account .... Dr.	3,000	
Unearned Commission Account		3,000

As a result, the commission A/c shows a credit balance of Rs. 3000 (6000 - 3000) and it will be shown on the credit side of profit and loss A/c. On the other hand unearned commission A/c shows a credit balance of Rs 3,000 and it will be shown on the liability side of Balance Sheet.

Double effect on Final Accounts

Unearned Revenue

- Deducted from the Concerned revenue A/c in P & L A/c (Credit side).
- Shown on the liability side of Balance Sheet as "unearned revenue".

Now look at the Profit and Loss A/c and Balance Sheet given below :

Profit and Loss A/c for the year ended 31.12.90

				Rs.
		Commission received	6,000	
		Less unearned Commission	3,000	3,000

Balance Sheet

Assets	Rs.	Liabilities	Rs.
		Unearned Commission	3,000

2. Under this method, when a revenue is received, it is treated as a liability, as it has been received in advance. On receiving a revenue in cash, cash account is debited and concerned unearned revenue account (a liability A/c) is credited. At the end of the accounting period a portion of the revenue received (against which the services have been provided till the end of the year) is transferred to a concerned revenue account by debiting unearned revenue A/c and crediting the concerned revenue A/c.

In the above mentioned example, when commission is received, the following entry will be passed;

	Rs.	Rs.
Cash Account ....Dr.	6,000	
Unearned Commission Account		6,000

At the end of the year, when a portion of the amount is transferred to revenue, the following entry will be passed:

	Rs.	Rs.
Unearned commission Account ....Dr.	3,000	
Commission Account		3,000

As a result, the commission A/c is showing a credit balance of Rs. 3,000 and unearned commission A/c is showing a credit balance of Rs. 3,000.

It may be noted that under both the methods the result is the same, commission A/c shows a credit balance of Rs. 3,000 and unearned commission A/c shows a credit balance of Rs. 3,000.

ILLUSTRATION NO. 2

The Trial Balance of a trader as on 31.12.1990 is given below:

	Debit Rs.		Credit Rs.
Opening stock	60,000	Bills Payable	10,000
Sundry Debtors	80,000	Returns outward	2,400
Furniture	20,000	Capital	1,40,000
Plant	1,00,000	Commission received	1,000
Purchases	3,40,000	Sales	4,62,000
Bills Receivable	22,000	Interest received	400
Carriage Inward	2,600	Creditors	80,000
Carriage Outward	1,800		
Insurance paid	1,400		
Returns Inward	4,000		
Salaries	24,000		
Wages	20,000		
Cash at Bank	18,000		
Cash in hand	2,000		
	6,95,800		6,95,800

Prepare a Trading and Profit and Loss A/c for the year ended 31.12.1990 and a Balance Sheet as at that date after taking into consideration the following adjustments,

1. **Closing stock valued at Rs. 1,00,000**
2. **Outstanding salaries Rs. 6,000 and outstanding wages Rs. 1,000.**
3. **Insurance included a sum of Rs. 350 relating to the next year, 1991.**
4. **Commission received in advance (unearned) is Rs. 300**
5. **Interest receivable for the year, 1990 is Rs. 200.**

Solution :

Dr. **Trading and Profit and Loss A/c for the year ended 31.12.1990** Cr.

Opening Stock		60,000	Sales :	462000	
Purchases :	3,40,000		Less returns	4000	4,58,000
Less returns	2,400	3,37,600			
Carriage Inward		2,600	Closing stock		1,00,000
Wages	20,000				
+ outstanding wages	1,000	21,000			
Gross Profit c/d		1,36,800			
		5,58,000			5,58,000
Carriage outward		1,800	Gross Profit b/d		1,36,800
Insurance :	1400		Commission received.	1000	
Less Prepaid.	350	1,050	Less unearned	300	700
Salaries	24,000		Interest received	400	
+ outstanding salaries	6,000	30,000	+ Accrued Interest	200	600
Net Profit (transferred to capital A/c)		1,05,250			
		1,38,100			1,38,100

Balance Sheet as at 31.12.1990

Assets	Rs.	Liabilities		Rs.
Current Assets		**Current Liabilities**		
Cash in hand	2,000	Bills Payable		10,000
Cash at Bank	18,000	Creditors		80,000
Sundry Debtors	80,000	Outstanding wages		1,000
Bills Receivable	22,000	Outstanding Salaries		6,000
Closing Stock	1,00,000	Unearned Commission		300
Prepaid Insurance	350			
Accrued Interest	200	**Fixed & Long Term**		
Fixed Assets		**Liabilities**		
Furniture	20,000	Capital	140,000	
Plant	1,00,000	+ net profit	105250	2,45,250
	3,42,550			3,42,550

5. DEPRECIATION OF ASSETS :

Depreciation means loss on account of use of an asset or decrease in its value on account of passage of time or decrease in its efficiency because of its usage in monetary terms. Depreciation is a loss to the business. So unless it is considered like other expenses and losses, true profit/loss cannot be ascertained. In other words, depreciation must be considered in order to find out true profit/loss of a business. As we know, assets are used up gradually in a business for a number of years. Each year, a portion of the usefulness of these assets expires and this portion of their total cost should be recognised as an expense. Failure to record depreciation would result in understating total expenses of the period and consequently overstating the net profit.

For example, suppose, a machine is bought for Rs. 50,000. Its value must diminish gradually on account of use ___ the more it is used, the more will it diminish in value. After sometimes it will become unfit for use. Then a new machine is to be bought. Suppose, the estimated life of machine is 20 years. In that case the annual loss on account of depreciation will be Rs. 2,500 (50,000 ÷ 20). It must be debited to Profit and Loss A/c; otherwise the true result cannot be obtained and the Balance Sheet will not disclose the true financial position of the business.

Similarly, depreciation must be taken into account in respect of all other assets like building, furniture, office equipment etc.

The following entry is passed at the end of the year on account of depreciation;

	Rs.	Rs.
Depreciation Account ....Dr.	xx	
Asset Account		xx

In the above mentioned example, the following entry will be passed on account of depreciation of machine.

	Rs.	Rs.
Depreciation Account ....Dr.	2,500	
Machinery Account		2,500

Depreciation also has double effect on Final Accounts;

Accrued Revenue

Shown on the debit side of P & L A/c	Shown on the asset side of Balance Sheet "as deduction from concerned asset".

NOTE:

In examination problems depreciation is usually mentioned at certain per cent per annum (% p.a.) on the cost of asset, e.g. 5% p.a. of building or furniture etc. If an asset is purchased in the current year, depreciation is to be charged for the period from the date of purchase up to the end of the year. If the date of purchase is not mentioned, depreciation should be charged for 6 months, on the assumption that the asset has been purchased in the middle of the year. A note to that effect must be added. Detailed discussion about depreciation is given in a 'separate chapter'.

6. INTEREST ON CAPITAL AND OWNER'S SALARIES:

A business is regarded as an economic unit distinct from the owner/owners and the amount invested by the owner/owners is regarded as liability of the business (business has borrowed this money from the owner). The money borrowed by a business from its owner / owners is known as capital. When a business borrows money from a bank or from a private individual, it pays interest on the borrowed money and this interest is considered as an expense of the business and is charged to profit and loss A/c. In the same way, the profit of the business is only justified, if interest on capital (interest on money borrowed from the owner) is also regarded as an expense of the business and is charged to profit and loss A/c along with other expenses. Moreover, interest on capital is regarded as an expense of the business because if the owner would invest, elsewhere an amount equal to the amount of capital invested in the business, he would have obviously earned some income i.e. investment in the Government securities or certificates etc. This is known as normal income or normal profit. The interest on capital (at normal rate) is charged to Profit and Loss A/c in order to see whether the business is earning extra profit over and above the normal profit. The owner will have to earn extra profit over and above the normal profit in order to cover un-certainties and risks involved in business. The more the risk, the more should be the amount of extra profit. This extra profit is regarded as true profit of the business. Similarly, owner's salary is also regarded as an expense of the business and is charged to Profit and Loss A/c.

At the end of the year when interest on capital is recorded , the following entry is passed,

	Rs.	Rs.
Interest on Capital Account ....Dr.	xx	
Capital Account		xx

When owner's salary is taken into account, the following entry is passed,

	Rs.	Rs.
Owner's Salary Account ....Dr.	xx	
Capital Account		xx

The effect on Final Accounts is illustrated below:

Interest on Capital

Shown on the debit side of P & L A/c

Shown on the Liability side of Balance Sheet "as addition to capital".

Owner's Salary

Shown on the debit side of P & L A/c

Shown on the Liability side of B/S "as addition to capital".

7. INTEREST ON DRAWINGS :

The interest on drawings is exactly opposite of interest on capital when interest is allowed on capital and is regarded as an expense of the business, then it is very much logical that business should also charge the owner with interest on his drawings. This interest on drawings is a revenue to the business and is credited to profit and loss A/c.

The following adjusting entry will be passed to record interest on drawings at the year end:

		Rs.	Rs.
Drawings Account	Dr.	xx	
Interest on Drawings Account			xx

The effect of interest on drawings on Final Accounts is illustrated below:

Interest on Drawings

Shown on the credit side of P & L A/c as 'revenue'

Added to Drawings and total drawings are deducted from capital on the liability side of B/S.

ILLUSTRATION NO. 3

Prepare Trading Account and Profit and Loss Account for the period ending on 31st December, 1991 and a Balance Sheet as at that date from the following Trial Balance of Naseem Trading Company.

	Debit Rs.	Credit Rs.
Stock (1.1.1991)	1,15,200	
Cash in hand	10,800	
Cash at Bank	52,600	
Purchases	8,13,500	
Returns Inward	13,600	
Wages	1,69,600	
Fuel and Power	94,600	
Carriage on sales	64,000	
Carriage on Purchases	40,800	
Buildings	6,40,000	
Free hold Land	2,00,000	
Machinery	4,00,000	
Patents	1,50,000	
Salaries	3,00,000	
General expenses	60,000	
Drawings	12,000	
Insurance	1,04,900	
Sundry Debtors	2,90,000	
Sales		19,75,600
Returns outwards		10,000
Capital		12,40,000
Sundry Creditors		1,26,000
Rent		1,80,000
	35,31,600	35,31,600

The following additional information is supplied to you :

(1) Stock in hand on 31st December, 1991 is Rs. 1,36,000.

(2) Machinery and Building are to be depreciated at the rate of 10% p.a. and Patents at the rate of 20%.

(3) Salaries for the month of December, 1991 amounting to Rs. 30,000 are unpaid.

(4) Insurance is paid in advance to the extent of Rs. 13,000.

(5) Rent receivable is Rs. 20,000.

(6) Charge interest on capital at 10% and on drawings at 5%.

Solution:

Naseem Trading Co.

Dr. Trading and Profit and Loss A/c for the year ended 31.12.1991 Cr.

		Rs.			Rs.
Opening Stock		1,15,200	Sales :	1975600	
Purchases :	8,13,500		Less returns	13600	19,62,000
Less returns	10,000	8,03,500	Closing stock		1,36,000
Wages		1,69,600			
Carriage on Purchases		40,800			
Fuel and Power		94,600			
Gross profit c/d		8,74,300			
		20,98,000			20,98,000
Carriage on sales		64,000	Gross Profit b/d		8,74,300
Salaries:	3,00,000		Rent received	180,000	
+ unpaid	30,000	3,30,000	+ receivable	20,000	2,00,000
General expenses		60,000	Interest on Drawings		600
Insurance :	1,04,900				
Less paid in advance	13,000	91,900			
Depreciation :					
40,0000 × 10/100 Machinery	40,000				
640,000 × 10/100 Building	64,000				
150,000 × 20/100 Patents	30,000	1,34,000			
Interest on Capital		1,24,000			
Net Profit (transferred to capital)		2,71,000			
		10,74,900			10,74,900

NASEEM TRADING CO.

Balance Sheet as at 31.12.1991

Assets		Rs.	Liabilities			Rs.
Current Assets			**Current Liabilities**			
Cash in hand		10,800	Outstanding Salaries			30,000
Cash at Bank		52,600	Creditors			126000
Sundry Debtors		2,90,000	**Fixed & Long-Term Liabilities**			
Closing Stock		1,36,000	Capital		12,40,000	
Accrued rent		20,000	+ Net profit		2,71,000	
Prepaid Insurance		13,000	+ Interest on Capital		1,24,000	
Fixed Assets					16,35,000	
Machinery	4,00,000					
Less depreciation	40,000	3,60,000	Less: Drawings	12,000		
Building	6,40,000		+ interest			
Less depreciation	64,000	5,76,000	on drawings	600	12,600	16,22,400
Patents	1,50,000					
Less depreciation	30,000	1,20,000				
Land		2,00,000				
		17,78,400				17,78,400

NOTE:

1. Patents mean the right of the business to manufacture or sell a product, so they are shown on the asset side of Balance Sheet.
2. Interest on drawings has been first added to the drawings and then total drawings have been deducted from the capital.

BAD DEBTS AND PROVISION FOR DOUBTFUL DEBTS OR UNCOLLECTIBLES AND ALLOWANCE FOR UNCOLLECTIBLES:

No business concern wants to sell goods or services to a customer on credit basis who may prove unable or unwilling to pay his debts. Consequently, most business concerns have a credit department which makes investigation about the debts paying ability of each prospective customer. Regardless of how thoroughly the credit department investigates prospective customers, some bad debts will arise as a result of errors in judgments or because of unexpected developments. So, bad debts are caused by selling goods on credit to customers who fail to pay their debts.

In these days most of the goods are usually bought and sold on credit. When a business sells goods to customers on credit basis, the customers become its debtors and the amount due from the debtors is called "Debts". For example, suppose, Rehman sold to Asif goods for Rs. 1,000 and to Qasim for Rs. 3,000 on credit. Here Asif and Qasim are debtors of Rehman and debts due from them are Rs. 4000 (1000 + 3000).

Debts may be divided into three classes :

Debts

Bad Debts | Doubtful Debts | Good Debts

The different classes of debts are discussed below :

1. BAD DEBTS:

The debts which are irrecoverable from the debtors (i.e. cannot be realised) are called **Bad debts** and the concerned debtors are called **Bad debtors**. In the above example, suppose, if Rehman fails to recover Rs. 1,000 from Asif, it will be a bad debt to Rehman and Asif will be regarded as bad debtor. It is undoubtedly a loss to Rehman, so in books of Rehman it must be recorded as a loss on account of bad debt. The entry is:

	Rs.	Rs.
Bad debts Account ....Dr.	1,000	
Asif Account		1,000
(Being the amount written off as bad debt)		

Asif A/c

	Rs.		Rs
Balance b/d	1,000	Bad debts A/c	1,000

Bad debts A/c

	Rs.		
Asif A/c	1,000		

It may be noted that in ledger of Rehman, Asif A/c has been closed as a result of recording bad debt in it. Before recording bad debt, Asif A/c showed a debit balance of Rs. 1,000 ____ it means Asif was

debtor (an asset) of Rehman. Now that amount has become bad, it can no longer be regarded as an asset. So Asif A/c has been written off by crediting it with Rs. 1000. To **write off** a debtor's A/c it is to reduce the balance of debtor's A/c to zero. On the other hand, bad debt is our loss, it will be transferred to the debit of P & L A/c at the year end. For this the entry is:

	Rs.	Rs.
Profit and Loss A/c....................Dr.	1,000	
Bad debt Account		1,000
(Being transfer of Bad debts A/c to P & L A/c)		

Bad debt is a loss to the business; it arises out of credit sales. Hence bad,debt can be avoided, if credit sales are discontinued and all the goods are sold in cash only. But in actual practice it is not possible to sell goods in cash only. Goods must be sold on credit ____ otherwise the business will stand still. Further profit on credit sales generally exceeds the loss arising on account of bad debts. That is why goods are sold on credit.

There is no hard and fast rule for determining **when a debt may become irrecoverable.** The fact that a debtor fails to pay his debt on the due date in accordance with sales contract does not necessarily indicates uncollectibility. Generally, because of the following factors, a debt is regarded as bad:

1. Bankruptcy of the debtor.
2. Disappearance of debtor's business.
3. Disappearance of the debtor.
4. Failure of repeated attempt to collect the debt.

2. DOUBTFUL DEBTS:

The debts, the recovery or realisation of which is doubtful or uncertain, are known as **"Doubtful Debts"**. It is an expected or possible loss to the business. So, it is necessary to estimate the loss to be suffered on account of doubtful debts and make a provision therefore by debiting P & L A/c at the year end. This is known as **"Provision for Doubtful Debts"**.

Distinction between Bad Debt and Doubtful Debt:

Both bad debt and doubtful debt are loss to the business and are shown on the debit side of P & L A/c along with other expenses and losses at the year end. Yet there are some differences between the two as stated below:

Bad Debt	Doubtful Debt
1. It is a definite loss to the business.	1. It is an expected or possible loss to the business.
2. There is no possibility of recovery of bad debt. In rare cases, however, bad debt may be recovered. Hence, the whole amount of bad debt is a loss.	2. Doubtful debt may be recovered in future. Hence, the whole amount of doubtful debt may not be a loss.
3. No provision is necessary for bad debt, as provision is always made against an expected loss.	3. Provision is necessary for it.
4. Debtor Account is closed by crediting it with bad debt.	4. Debtor Account is not credited with it __ instead provision for Doubtful Debt A/c is credited.
5. It is not shown in Balance Sheet.	5. It is shown on Asset side of Balance Sheet under the head "Provision for Doubtful Debt" as deduction from Sundry Debtors.

NECESSITY FOR PROVISION FOR DOUBTFUL DEBT:

Provision means setting aside an amount out of profit for a possible loss or liability, the amount of which cannot be determined exactly.

A portion of the debt arising out of credit sales of the year 1 may prove bad in year 2. Such bad debt is regarded as a loss for the year 1. If such bad debt is charged to the P & L A/c of year 2, the profit of the year 1 will be more by the amount of such bad debt, while the profit of year 2 will be less to the same extent. As we know in finding out the profit, one of the most fundamental principles of accounting is that **revenue of the current year must be matched with the expenses and losses incurred in the current year.** Since it is not possible to determine exactly the portion of current year's debt which will turn bad next year, it is necessary to make a provision therefore. If it was possible to determine it exactly, there would have been no necessity for creating provision __ the amount would be straightway debited to P & L A/c as bad debt.

Thus in order to right the wrong, the amount of bad debt that may be incurred in year 2 on account of credit sales of year 1, is estimated at the end of year 1 and a provision is made therefore by debiting P & L A/c for the year 1.

Again if such provision is not made, Sundry Debtors in Balance Sheet will appear at a figure larger than their true value, i.e. the amount that will actually be collected from debtors. As a result, Balance Sheet will not disclose the true financial position of the business. Therefore, an account styled "Provision for Doubtful Debt A/c" is opened and the following entry is made at the end of the year 1:

	Rs.	Rs.
Profit & Loss Account ....Dr.	xx	
Provision for Doubtful Debt A/c		xx

In the balance sheet provision for doubtful debt is deducted from Sundry Debtors and the net amount is shown. The net amount indicates the amount which will actually be collected from the debtors.

Profit and Loss A/C Year 1

Provision for Doubtful Debt xx	

BALANCE SHEET

Assets	Rs.	Liabilities	Rs.
Sundry Debtors .... Less provision for Doubtful Debt			

Now question is, how much provision we should make for doubtful debts at the end of each year? Obviously, it depends upon the total amount of debtors at the end of the year. More are the debtors, more are the doubtful debts.

For example, suppose, on 31st December, 1985, the sundry debtors are amounted to Rs. 40,000. On the basis of past experience, it is estimated that 5% of the sundry debtors are doubtful. So, a provision is created for doubtful debts equal to Rs. 2,000 (40,000 x 5/100) by passing the following entry:

31.12.1985

Provision for doubtful debts has a credit balance of Rs. 2000.

		Rs.	Rs.
P & L A/c .... Dr.		2,000	
Provision for doubtful debts A/c			2,000

As a result, an amount of Rs. 2,000 is debited to P & L A/c as a possible loss and an amount of Rs. 2,000 is credited to 'provision for Doubtful debts A/c' which will be deducted from the debtors in Balance Sheet. This provision has been created to meet bad debts that may occur during the year 1986 but are related to the year, 1985. The credit balance of this account will appear in the Trial Balance of the year, 1986.

Suppose, at the end of year, 1986, the actual bad debts are Rs. 1,600. These bad debts are transferred to provision for Doubtful debts A/c by passing the following entry:

31.12.1986

Provision for D.D.A/c has a credit balance of Rs. 400.

	Rs.	Rs.
Provision for Doubtful debts A/c . Dr.	1,600	
Bad debts A/c		1,600

As a result, after setting off the bad debts against the provision for doubtful debts A/c, the provision for Doubtful debts A/c has still a credit balance of Rs. 400 (2000 - 1600).

Now, we have to create a provision for bad debts that may occur during the year, 1987 but are related to the year, 1986. Again, it depends upon the amount of debtors at the end of the year, 1986. Suppose, on 31st December, 1986 the sundry debtors are amounted to Rs. 25,000 and again 5% provision is to be created. It means the provision we require for the next year is Rs. 1,250 (25,000 × 5/100). We already have a credit balance of Rs. 400 in provision for Doubtful Debts A/c. So a further provision of Rs. 850 (1250 - 400) will be created at the end of the year, 1986 by passing the following entry:

31.12.1986	Rs.	Rs.
P & L Account .... Dr.	850	
Provision for Doubtful Debts A/c		850

Consequently, the provision for doubtful debts A/c has a credit balance of Rs. 1,250 (existing provision Rs. 400 + New provision Rs. 850). Again this account be appear in the Trial Balance of the year, 1987 and the same procedure will be repeated.

HOW BAD DEBTS & PROVISION FOR DOUBTFUL DEBTS ARE TREATED IN FINAL ACCOUNTS:

1. TREATMENT IN PROFIT AND LOSS A/C:

If there is a provision for Doubtful Debts A/c already existing in books (Trial Balance), Bad debts are not transferred to P & L A/c ___ they are transferred to the debit of Provision for Doubtful Debts A/c. Thereafter the difference between the opening balance of Provision for Doubtful Debts A/c and the total of bad debts and the current year's provision is transferred to P & L A/c. If the opening balance is less, the deficit is debited to P & L A/c and if the opening balance is more, the excess is credited to P & L A/c.

For an easy understanding of the effect of Bad debts and Provision for doubtful debts, the following three points should be noted carefully:

1. The provision given in the **"Trial Balance"** is always the old provision which has been created at the end of the previous year.
2. Bad debts may be given in the Trial Balance or outside the Trial Balance (in adjustments) or both in Trial Balance and in adjustments.
3. The provision given outside the Trial Balance (in adjustments) is always the new provision which is to be created at the end of the current year.

The effect of bad debts and provision for doubtful debts on P & L A/c may be shown in the form of a **"Formula"**,

{New provision for Doubtful debts + Bad debts given in Trial Balance + Bad debts given in adjustments - old or existing provision for Doubtful debts = the amount shown on the debit/credit side of P & L A/c}

It is further summarised as follows:

{New provision + Total Bad debts} - old provision = the amount shown in P & L A/c.

OR

{N + B - 0 = amount shown in P & L A/c}

If total of N and B is more than 0 , the excess amount will be shown on the **debit side of P & L A/c** and if total of N and B is less than 0, the deficit (difference) will be shown on the credit side of P & L A/c.

2. EFFECT OF BAD DEBTS AND PROVISION FOR DOUBTFUL DEBTS ON BALANCE SHEET:

The amount of provision for Doubtful Debts credited at the end of the current year (new provision) is **deducted from sundry debtors on the asset side of Balance Sheet**. Moreover, if bad debts are given outside the Trial Balance (in adjustments), **they are also deducted from sundry Debtors on the asset side of Balance Sheet**.

ILLUSTRATION NO. 4

Show how the following items will appear in Profit and Loss A/c :

Bad debts	**Rs. 1,600**
Provision for Doubtful Debts opening balance (old)	**Rs. 2,000**
Current year's provision (New).	**Rs. 800**

Solution:

Dr. **Profit and Loss A/c for the year ended** Cr.

		Rs.	
Provision for Doubtful Debts:			
New Provision =	800		
+ Bad debts =	1600		
	2400		
- old provision =	2000	400	

800 + 1600 -2000 = 400

ILLUSTRATION NO. 5

Show how the following items will appear in Profit and Loss A/c :

Bad Debts	Rs. 3,600
Provision for Doubtful Debts (old)	Rs. 6,000
Current year's provision (New)	Rs. 1,500

Solution:

In this case old provision is more than the total of Bad debts and new provision, so the difference is shown on the credit side of P & L A/c.

Profit and Loss A/c for the year ended ________

1500 + 3600

-6000 = -900

			Rs.
	Provision for Doubtful Debts :		
	New provision =	1500	
	+ Bad debts =	3600	
		5100	
	- old provision =	6000	900

ILLUSTRATION NO. 6

On 1.1.1990, the Provision for Doubtful Debts A/c stood at Rs. 12,000 (credit Balance). In 1990, the bad debts amounted to Rs. 10,000. The debtors on 31.12.1990 are amounted to Rs. 3,20,000 and a provision for doubtful debt is to be maintained at 5%. Show journal entries and the necessary accounts. Also show how the items will appear in Balance Sheet as at 31.12.1990.

Solution:

JOURNAL

16,000 + 10,000

-12,000 = 14,000

			Rs.	Rs.
31.12.90	Provision for Doubtful Debts A/c ... Dx.		10,000	
	Bad Debts A/c			10,000
	(Being the transfer of bad debts account)			
"	Profit and Loss A/c .... Dr.		14,000	
	Provision Doubtful Debt A/c			14,000
	(Being the additional amount required to raise the provision to 5 % of debtors).			

LEDGER

Bad Debts A/c

Dr. Cr.

1990			Rs.	1990			Rs.
31st Dec.	Debtors A/c		10,000	31st Dec.	Provision for Doubtful Debts A/c		10,000

Dr. **Provision for Doubtful Debts Account** Cr.

			Rs.				Rs,
31.12.90	Bad debts A/c		10,000	31.12.90	Balance b/d		12000
	Balance c/d		16000		P & L A/c		14000
	(5 % of 320000)				{10,000+16000 - 12000}		
			26000				26000
				1.1.91	Balance b/d		16000

Profit & Loss A/c for the year ended 31.12.1990

Dr. Cr.

	Rs.		Rs.
Provision for Doubtful Debts :			
New Provision : 16000			
+ Bad debts : 10000			
26000			
- old provision 12000	14000		

16000 + 10,000 - 12000 = 14000

Balance Sheet
as at 31.12. 1990

Dr. Cr.

Assets	Rs.	Liabilities	Rs.
Sundry debtors : 3,20,000			
Less provision			
for Doubtful debts 16,000	3,04,000		
@ 5%			

Only new provision is deducted from debtors.

ILLUSTRATION NO. 7

The following is the Trial Balance of Karim Corp. on 31st December, 1990. From this, you are required to prepare Trading and Profit and Loss A/c for the year ended 31st December, 1990 and a Balance Sheet as at that date:

	Debit Rs.		Credit Rs.
Plant & Machinery	1,50,000	Sales	8,41,500
Furniture	15,000	Sundry creditors	30,000
Purchases	4,50,000	Bills Payable	3,800
Stock (1.1.1990)	90,000	Provision for Doubtful Debts	2,400
Trade expenses	20,000	Capital	1,48,200
Carriage Inwards	5,000		
Carriage Outwards	3,000		
Discount	700		
Factory rent	3,000		
Insurance	1,400		
Debtors	1,17,000		
Office rent	6,000		
Postage & Stationery	1,200		
Printing Charges	5,600		
Bad debts	3,000		
Advertisement	30,000		
Bills Receivable	12,000		
Drawings	12,000		
Salaries	30,000		
Wages	40,000		
Coal & Gas	2,000		
Cash at Bank	25,000		
Cash in hand	4,000		
	10,25,900		10,25,900

ADJUSTMENTS:

(1) Closing stock is Rs. 70,000.

(2) Depreciate Plant and Machinery at 10% and furniture at 5%.

(3) Create provision on debtors at 5%.

(4) Prepaid Insurance being Rs. 200.

Solution:

Trading & Profit and Loss Account for the year ending 31.12.1990

Dr. Cr.

	Assets	Rs.	Liabilities	Rs.
	Opening Stock	90,000	Sales :	8,41,500
	Purchases :	4,50,000	Closing stock	70,000
	Carriage Inward	5,000		
	Factory rent	3,000		
	Wages	40,000		
	Coal and gas	2,000		
	Gross Profit c/d	3,21,500		
		9,11,500		9,11,500
	Trade expenses	20,000	Gross Profit b/d	3,21,500
	Carriage outwards	3,000		
	Discount	700		
	Insurance: 1400			
	Less prepaid <u>200</u>	1,200		
	Office rent	6,000		
	Postage & Stationery	1,200		
	Printing Charges	5,600		
	Advertisements	30,000		
	Salaries	30,000		
	Depreciation :			
1,50,000 x 10/100	Plant & Machinery	15,000		
15,000 x 5/100	Furniture	750		
	Provision for Doubtful debts.			
	New provision : 5,850			
5,850 + 3,000	+ Bad debts <u>3,000</u>			
- 2,400 = 6,450	8,850			
	- old provision <u>2,400</u>	6,450		
	Net Profit (transferred to capital A/c)	2,01,600		
		3,21,500		3,21,500

Balance Sheet
as at 31.12.1990

Assets		Rs.	Liabilities		Rs.
Current Assets			**Current Liabilities**		
Cash in hand		4000	Sundry creditors		30,000
Cash at Bank		25000	Bills Payable		3800
Sundry Debtors	117000		Capital	148200	
Less provision for			+ Net Profit	201600	
Doubtful debts :	5850	111150		349800	
Bills Receivable		12000	Less Drawings	12000	337800
Closing Stock		70,000			
Prepaid Insurance		200			
Fixed Assets					
Plant & Machinery	150,000				
Less depreciation	15000	135000			
Furniture	15000				
Less depreciation	750	14250			
		371600			371600

NOTE :

Only new provision for Doubtful Debts has been deducted from sundry debtors in Balance Sheet.

RECOVERY OF BAD DEBTS :

The debts may be collected after they have been written off as bad. This is known as 'Recovery of Bad Debts'. For example, suppose, a debtor, Aslam failed to pay Rs. 500 and his account has been written off as bad (has been closed). But after a long period of time he repays his debt. It will be recorded in books of accounts by passing the following entry:

		Rs.	Rs.
Cash account	Dr.	500	
Bad debts recovered A/c			500

(Being the amount recovered from Aslam previously written off as bad).

It should be remembered that recovery of bad debts is regarded as a revenue (profit). So it should not be credited to Bad Debts A/c rather it should be credited to Bad Debts Recovered A/c and subsequently transferred to the credit side of P & L A/c at the end of the year. The entry is,

		Rs.	Rs.
Bad Debts Recovered A/c	Dr.	500	
Profit and Loss A/c			500

(Being transfer of bad debts recovered to P & L A/c).

PROVISION FOR DISCOUNT ON DEBTORS :

Discount may be allowed to debtors, if they will pay their debts before the due date. For discount to be allowed to debtors, a provision should be created in the same manner as is done in the case of doubtful debts because such discount is also a possible loss to the business. This is known as 'Provision for Discount on Debtors'. Here the same procedure is followed and similar entries are passed as in the case of provision for doubtful debts. In both the cases provision is created at certain percentage of the amount of debtors. The only difference is that **Provision for discount is created on good debts (i.e. Total debtors -- bad debts in adjustment if any -- provision for Doubtful Debts) because there is no question of allowing discount on doubtful debts or bad debts**. For example, suppose the particulars are as follows:

	Sundry Debtors	Rs.	10800
	Bad debts given in adjustment	Rs.	800
	Provision for doubtful debts at 5% of debtors		
	provision for discount on debtors at 2%.		
	Provision for discount is calculated as follows:		
	Sundry Debtors	Rs.	10800
	Less Bad debts		800
			10,000
10,000 x 5/100	Less provision for doubtful debts @ 5%		500
	Good debts		9500

Now provision for discount will be Rs. 190 (9500 x 2/100).

The entry will be:

	Rs.	Rs.
Profit and Loss A/c .... Dr.	190	
Provision for discount A/c		190

It will be recorded on the debit side of P & L A/c and will be shown on the asset side of Balance Sheet as a deduction from sundry Debtors.

Profit and Loss A/c

	Rs.	
Provision for discount	190	

Assets **BALANCE SHEET** Liabilities

		Rs.	
Sundry Debtors	10800		
- Bad debts	800		
	10,000		
- Provision for doubtful debts:	500		
	9500		
- Provision for discount	190	9310	

NOTE:

(1) If discount allowed and provision for discount (old provision for discount) is given in Trial Balance, then we should apply the following formula,

New Provision for discount + Discount allowed - old provision for discount = The amount shown in P. & L A/c.

(2) If Bad Debts are given in Trial Balance, they are not deducted from sundry debtors before the calculation of Provision for discount. In that case provision for discount will be calculated in the following way:

	Rs.
Sundry Debtors :	10,800
- Provision for doubtful debts at 5%	540
Good debts	10,260

Provision for discount will be Rs. 205 (10,260 x 2/100).

PROVISION FOR DISCOUNT ON CREDITORS:

We allow discount to our debtors and in the same way we may also receive discount from our creditors. Such a discount is an expected revenue (gain or profit). So provision is created at the year end for the estimated amount of discount receivable from creditors. This is known as 'provision or reserve for discount on creditors'. This provision or reserve is calculated as certain percentage of total creditors. For example, suppose the particulars are as follows:

	Rs.
Sundry creditor	24000

Provision for discount on creditors @ 3%.

Provision for discount will be Rs. 720 (24000 x 3/100).

The entry is:

		Rs.	Rs.
Provision for discount on Creditors A/c	Dr.	720	
Profit and Loss A/c		720	

It will be shown on **the credit side of P & L A/c and in Balance Sheet as a deduction from sundry creditors.**

ILLUSTRATION NO. 8

From the following Trial Balance of Karim Bros. prepare a trading and profit and loss A/c for the year ended 31.12.1990 and also a Balance Sheet as on the above date.

	Debit	*Credit*
	Rs.	***Rs.***
Stock on 1.1.1990	**24200**	
Purchases	**4,000**	
Sales		**119600**
Capital		**183200**
Drawings	**8400**	
Furniture	**24000**	
Salaries Outstanding		**2600**
Sundry Debtors	**33600**	
Sundry Creditors		**25000**
Income Tax	**1200**	
Machinery	**36000**	
Building	**80 000**	
Investment in 10 % Govt. securities	**16000**	
Wages	**24000**	
Salaries	**25000**	
General Expenses	**6000**	
Cash at Bank	**6000**	
Cash in hand	**4000**	
	330400	**330400**

ADJUSTMENTS:

1. **Depreciate Building at 2 % p.a., machinery at 5 % p.a. and furniture at 10 % p.a.**
2. **Provide for doubtful debts @ 5 % and for discount @ 5 % on sundry debtors.**
3. **Create reserve for discount on creditors @ 3 %.**
4. **Wages payable Rs. 3000.**
5. **Stock on 31.12.1990 is Rs. 32600.**

Solution:

KARIM BROS.

TRADING AND PROFIT AND LOSS A/C

Dr. For the Year Ended 31.12.1990 Cr.

			Rs.		Rs.
	Stock Opening		24200	Sales:	119600
	Purchases		41000	Closing Stock	32600
	Wages:	24000			
	+ Payable:	3000	27000		
	Gross Profit c/d		60,000		
			152200		152200
	Salaries		26000	Gross Profit b/d	60,000
	General Expenses		6000	Provision for discount	
	Depreciation:			on creditors	750
	Building:		1600	Interest on investment	
	Machinery:		1800	(10/100 × 16000)	1600
	Furniture		2400		
$33600 \times \frac{5}{1100}$	Provision for Doubtful debt :		1680		
$31920 \times \frac{5}{100}$	Provision for discount				
	on debtors		1596		
	N.P. (Transferred to Capital)		21274		
			62350		62350

NOTE:

(1) In case of sole proprietorship and partnership business **'income tax'** is not regard as an expense of the business — it is regarded as personal expense of the owner like 'Drawings', so it will be deducted from capital in Balance Sheet.

(2) Interest on Govt. securities has not been mentioned in Trial Balance — it means the whole amount of interest $\left(16000 \times \frac{10}{100}\right)$ on investment is accrued (receivable). It is shown on the credit side of P & L A/c and then on the asset side of Balance Sheet as accrued revenue.

(3) Outstanding salaries are given in the Trial Balance (not in adjustments), so they will not be added to salaries in P & L A/c. They will be shown on the liability side of Balance Sheet only.

KARIM BROS.
BALANCE SHEET
as at 31.12.1990

Assets		Rs.	Liabilities		Rs.
Current Assets:			**Current Liabilities:**		
Cash in hand		4000	Outstanding Salaries		2600
Cash at Bank		6000	Outstanding Wages		3000
Debtors:	33600		Creditors:	25000	
Less: Provision for			**Less:** Provision for		
doubtful debts:	1680		discount:	750	24250
	31920		Capital:	183200	
Less: Provision for			+ Net Profit	21274	
discount:	1596	30324		204474	
Closing Stock		32600	– Drawings	8400	
Investment		16000		196074	
Accrued interest on			– Income Tax:	1200	194874
Investment		1600			
Fixed Assets:					
Building:	80,000				
Less : depreciation:	1600	78400			
Machinery:	36000				
Less : depreciation:	1800	34200			
Furniture:	24000				
Less: deprecation:	2400	21600			
		224724			224724

SOME TYPICAL PROBLEMS IN FINAL ACCOUNTS:

While preparing Final Accounts a number of items require adjustment. Many of them have already been discussed earlier. Now a few typical items are taken up.

1. WITHDRAWAL OF GOODS BY THE PROPRIETOR FOR HIS PERSONAL OR PRIVATE USE:

Goods taken away by the proprietor from business for his private use are treated as his drawings and are debited to Drawings A/c. If Drawings A/c is given in Trial Balance, then the amount of Drawings will be deducted from capital in Balance Sheet. **But if drawings (goods taken away by the proprietor for private use) are mentioned in adjustments, then drawings are first deducted from 'Purchases' in Trading A/c and then are deducted from capital in Balance Sheet.**

Dr. **TRADING ACCOUNT** Cr.

Purchases		
Less drawings	....	

BALANCE SHEET

Assets		Liabilities	
		Capital	
		Less drawings	....

2. LOSS OF GOODS:

There may be a loss of goods in a business for some reasons. It is undoubtedly a loss to the business. From accounting viewpoint losses are of two types:

(a) Normal Loss:

There will be no entry in books of accounts, if goods are lost by normal reasons, e.g. loss on account of handling of goods, breakage, shrinkage etc. Obviously, in case of such loss the value of closing stock will be reduced by an amount equal to the amount of loss and if Trading A/c is credited with the reduced value of closing stock, the gross profit will also reduce automatically by the same extent. **So there is no need of passing separate entry for this type of loss, it will automatically be adjusted.**

(b) Abnormal Loss:

Sometimes goods may be lost on account of fire, flood or for some other abnormal reasons. Such loss cannot be charged to Trading A/c. Because, the percentage gross profit on sales is an important yardstick for assessing the trading condition of the business. If loss of goods by abnormal reasons is charged to Trading A/c, gross profit will be less and the percentage of gross profit on sales will also be less. In such a

case, it would be quite natural to think that the condition of the business is bad, compared to last year. But this is not correct. Abnormal loss does not occur every year – it is accidental and non–recurring by nature. So, this loss cannot be considered in determining gross profit, if the true condition of business is to be assessed. In other words, **Trading A/c is prepared on the assumption that there was no abnormal loss.** That is why Trading A/c will be credited with the amount of abnormal loss. The Journal entry is;

Abnormal Loss A/c .... Dr. x x

Trading A/c .... x x

The result of this entry is, the Trading A/c will show its true gross profit.

Dr. **Trading A/c** **Cr.**

	Abnormal Loss	......

Now question is – how to close Abnormal Loss A/c? It depends on whether the goods loss were insured or not.

(i) If loss is not Covered by Insurance:

In this case the whole amount of loss is shown on the debit side of P & L A/c by passing the following entry;

Profit and Loss A/c .... Dr. x x

Abnormal Loss A/c .... x x

Profit and Loss A/c

Abnormal Loss	......	

(ii) If Loss is Fully Covered by Insurance:

In this case the business will not have to bear any loss. The Insurance Company will compensate the loss in full. So, nothing will be debited to P & L A/c. The following entry will be made;

Insurance Claim A/c .... Dr. x x

Abnormal Loss A/c .... x.x

Insurance Claim A/c indicates the amount receivable from the Insurance Company and it is shown on the asset side of Balance Sheet.

(iii) If Loss is Partly Covered by Insurance:

In this case the business will have to bear loss to the extent not covered by insurance and the amount ·oss will be debited to P & L A/c. Suppose, goods worth Rs. 15000 are destroyed by fire which were :red from Rs. 9000 only. The net loss to the business will be Rs. 6000 (15000 – 9000). The entry will be

		Rs.	Rs.
Insurance Claim A/c	.... Dr.	9000	
Profit and Loss A/c	.... Dr.	6000	
Abnormal Loss A/c	....		15000

In this case loss of Rs. 6000 will be shown on the debit side of P & L A/c and insurance claim A/c will appear on the asset side of Balance Sheet;

Profit and Loss A/c

Dr.	Rs.	Cr.	
Abnormal Loss	6000		

Balance Sheet

Assets	Rs.	Liabilities
Insurance Claim	9000	

3. WHEN CLOSING STOCK IS GIVEN IN TRIAL BALANCE:

Closing stock figure is generally not available from Trial Balance, because it is obtained by valuing the goods lying unsold at the end of the year after the Trial Balance has been prepared.

Sometimes closing stock is given in the Trial Balance, it means, it has been adjusted with Purchase A/c with the help of following entry;

Stock (Closing) A/c .... Dr. x x

Purchase A/c .... x x

It indicates that Trial Balance has been prepared after passing the above entry. In that case the Purchases figure appearing in the Trial Balance will represent total purchases less closing stock. In order to indicate this the item "Purchases" in Trial Balance is marked by the word "adjusted" and shown as – **Purchases (adjusted).**

Thus if closing stock is given in Trial Balance, **it will not be shown on the credit side of Trading A/c, as it has already been deducted from purchases on the debit side of Trading A/c – it will only be shown on the asset side of Balance Sheet.**

4. GENERAL RESERVE OR RESERVE:

Usually in partnership business, a portion of profit is kept apart as 'general reserve' in order to strengthen the financial position of the business. It is created by debiting profit and loss A/c and crediting

General Reserve A/c and then **it is shown on the liability side of the Balance Sheet.** It always has a credit balance.

5. CONTINGENCY RESERVE:

A portion of profit is kept apart as 'contingency reserve' in order to meet future danger and difficulties. It is also **shown on the liability side of the Balance Sheet.**

6. LOAN: (MONEY BORROWED):

If money is borrowed from somebody for the purpose of business it is credited to 'Loan A/c'. Loan is liability of the business and is shown separately on the **Liabilities side of Balance Sheet under the head "Loan". If money is borrowed from a bank, then it will be shown on the liabilities side of Balance Sheet under the head "Bank Loan".**

For example, suppose we borrowed Rs. 50,000 from a bank at 10 % p.a. rate of interest. It means interest payable after one year will be Rs. 5000 $\left(50,000 \times \frac{10}{100}\right)$. This interest is an expense of the business and will be shown **on the debit side of P & L A/c.** If we have paid only Rs. 2500 as interest (which is given in the Trial Balance), it does not mean our expense is Rs. 2500. It is understood that interest of Rs. 2500 is outstanding (have not been paid). So, **on the debit side of profit and loss A/c, total interest Rs. 5000 (Interest paid Rs. 2500 + Interest outstanding Rs. 2500) will be shown and outstanding interest will also be shown on the liabilities side of Balance Sheet.**

7. LOAN GRANTED BY BUSINESS (MONEY LENT):

If a business has excess funds, it may lend money to somebody. In that case Loan A/c will have debit balance. Such loan is not liability of the business, rather it will be regarded as an asset of the business and **will be shown on the asset side of Balance Sheet.** The interest received on such loan is a revenue of the business and it will be shown **on the credit side of Profit and Loss A/c.**

8. DEPRECIATION GIVEN IN TRIAL BALANCE:

Depreciation is usually given as an adjustment item outside the Trial Balance. But in some cases depreciation may appear inside the Trial Balance, which means the entry for depreciation has already been passed. So the asset account appears in the Trial Balance at net value, i.e. depreciation has been deducted from the asset value. In such a case, **depreciation will not be deducted from the concerned asset in Balance Sheet – it will only be shown on the debit side of Profit and Loss A/c.**

9. PROFIT OR LOSS ON SALE OF FIXED ASSETS:

Fixed asset is not bought for resale. it is used by the business for a long time. But on account of its constant use it wears out and cannot be used after sometime, than it is sold out and a new asset is bought. These may be a profit or loss on sale of an asset. If there is loss, **it is shown on the debit side of profit and loss A/c, but if there is profit, it is not shown on the credit side of P & L A/c, rather it is shown on the liability side of Balance Sheet under the head "Capital Reserve".**

10. INTEREST ON LOAN:

If Loan A/c appears in Trial Balance and the rate of interest thereon is mentioned, interest will have to be paid at that rate. If no item of interest on loan appears in the Trial Balance, it will mean that interest has not been paid – it is payable or outstanding. For this the adjustment entry will be;

Interest on Loan A/c .... Dr. x x

Outstanding Interest on Loan A/c .... x x

Interest on Loan will be shown on the debit side of profit and loss A/c and outstanding interest on Loan A/c will be shown on the liabilities side of Balance Sheet.

For example, suppose on 31.12.1990, the following items appear in Trial Balance;

Loan @ 10 % p.a. (Taken on 1.1.1990)	Rs. 15000
Interest on Loan	Rs. 750

Here interest on Loan will be Rs. 1500 $\left(15000 \times \frac{10}{100}\right)$.

But interest has been paid Rs. 750 only. Therefore, interest has been outstanding for Rs. 750 (1500 – 750). It will be shown in Final Accounts as follows;

Dr. Profit and Loss A/c For the Year Ended 31.12.90 Cr.

		Rs.	
Interest Loan paid:	750		
+ Outstanding:	750	1500	

BALANCE SHEET AS AT 31.12.90

Assets	Rs.	Liabilities	Rs.
		Loan	15000
		Outstanding Interest Loan:	750

11. MANAGER'S COMMISSION:

Sometimes Manager is paid commission as certain percentage of net profit. Suppose, net profit is Rs. 14000 and Manager is paid commission at 10 % of net profit. Commission may be calculated by the following two methods;

(a) If statement is this – 10 % of net profit before charging Manager's Commission, then commission will be calculated as follows;

$$\text{Rs. } 14000 \times \frac{10}{100} = \text{Rs. } 1400$$

So, Manager's commission of Rs. 1400 will be shown on the debit side of Profit and Loss A/c.

(b) If statement is – 10 % of net profit after charging Manager's commission, then commission will be calculated in the following way;

$$\text{Rs. } 14000 \times \frac{10}{110} = \text{Rs. } 1273$$

So, Manager's commission of Rs. 1273 will be shown on the debit side of Profit and Loss A/c.

If nothing is mentioned of any particular method in question, either of the methods may be followed. A note must be added to this effect in the answer paper.

12. AGREEMENT OF BALANCE SHEET BY SUSPENSE A/C:

Sometimes in examination a list of balances is given instead of Trial Balance, in which case a Trial Balance should be prepared to see whether the Trial balance agrees or not. If it does not agree, the Balance Sheet will also not agree and it will be made to agree with the help of suspense A/c. **The amount of discrepancy will be written on the lesser side of Balance Sheet under the head "Suspense" and the Balance Sheet will agree.**

ADJUSTMENT OF ERRORS IN FINAL ACCOUNTS:

13. PURCHASES NOT RECORDED IN THE BOOKS BUT INCLUDED IN CLOSING STOCK:

For this the entry will be:

Purchase Account .... Dr. x x

Cash/Creditors A/c .... x x

It will be shown in Trading A/c as addition to Purchases and in Balance Sheet as deduction from cash or addition to sundry creditors.

14. PRIVATE PURCHASES RECORDED IN PURCHASES BOOK:

For this the adjusting entry will be;

Drawings A/c .... Dr. x x

Purchase A/c .... x x

It will be shown in Trading A/c as deduction from Purchases and in Balance Sheet as addition to Drawings.

15. PURCHASE OF ASSET PASSED THROUGH PURCHASES BOOK:

For this the adjusting entry will be;

Asset A/c .... Dr. x x

Purchases A/c .... x x

It will be shown in Trading A/c as deduction from Purchases and in Balance Sheet as an addition to concerned asset.

16. REVENUE EXPENDITURE TREATED AS CAPITAL EXPENDITURE:

Suppose regular repairs to building has been wrongly debited to Building A/c. For this the adjusting entry will be;

Repairs A/c .... Dr. x x

Building A/c .... x x

Repairs will be shown on the debit side of Profit and Loss A/c on Assets side of Balance Sheet as deduction from Building. it should be noted that the depreciation on Building will be calculated on the value of building after deduction of repairs.

17. CAPITAL EXPENDITURE RECORDED AS REVENUE EXPENDITURE:

Suppose, wages for the installation of machinery has been debited to wages. A/c. For this the adjusting entry will be:

Machinery A/c .... Dr. x x

Wages A/c .... x x

It will be shown in Trading A/c as deduction from wages and in Balance Sheet as addition to Machinery. It should be noted that depreciation will be calculated on the added value of Machinery.

18. INCOME TAX:

In case of sole proprietorship and partnership business, income tax is not levied on the concern but on its proprietor or partner's income. So any tax paid by the concern cannot be regarded as business expenditure – **it will be treated as drawings of the proprietor and will be added to Drawings on the liabilities side of Balance Sheet.**

ILLUSTRATION NO. 9

From the following Trial Balance of Bashir & Sons, prepare a Trading and Profit and Loss A/c for the year ending 31st December, 1991 and a Balance Sheet as on that after making the necessary adjustments:

	Debit	*Credit*
	Rs.	*Rs.*
Drawings	10,000	
Plant & Machinery	11640	
Depreciation on Plant & Machinery	360	
Leasehold Premises	8000	
Capital		63200
Loan from Bank at 5 %.		6400
Interest on Loan for Six months	160	
Loan to Mr. X at 5 %	7760	
Interest received on Loan for Six month		194
Purchases & sales	74400	191200
Returns	4000	1000
Opening Stock	49600	
Wages	6400	
Coal and Gas	3200	
Advertisement	11200	
Apprentice Fee for two years		19200
Salaries	27440	
Sundry Debtors and Creditors	33200	21600
Provision for Doubtful Debts:		5000
Building	14162	
Depreciation on Building at 3 %	438	
Addition to Building (on 31.12.1991)	3200	
Freight	2000	
Income Tax	1440	
Furniture Purchased on 31.12.1991	20,000	
Cash in hand	19194	
	307794	307794

ADJUSTMENTS:

1. **Stock valued on 31.12.1991 was Rs. 40000.**
2. **Write of Bad debts Rs. 2400.**
3. **Create a Provision on Debtors at 5 %.**
4. **Provide Commission of 2 % on the gross profit for works manager.**
5. **General Manager is entitled to a commission of 5 % on net profit after charging such commission.**
6. **Goods taken away by the proprietor for his private use were Rs. 3000, for which no entry was passed.**
7. **Their was a loss of goods by fire on 15th December, 1991, to the extent of Rs. 20,000, not covered by insurance.**

Solution:

BASHIR & SONS.
TRADING & PROFIT AND LOSS A/C
For the Year Ended 31.12.1991

	Dr.		Rs.			Rs. Cr.
	Opening Stock		49600	Sales:	191200	
	Purchases:	74400		**Less returns:**	**4000**	187200
	Less: returns:	**1000**		Closing Stock		40,000
		73400				
	Less: Goods drawn			**Loss by fire:**		**20,000**
	for personal use:	**3000**	**70400**			
	Wages		6400			
	Coal & Gas		3200			
	Freight		2000			
	Gross Profit c/d		115600			
			247200			247200
	Works manager			Gross Profit b/d		115600
	commission at 2 % of G.P.		2312	Interest on Loan:	194	
	Depreciation on Plant &			**+ Interest Accrued:**	**194**	**388**
	Machinery		360	Apprentice fee	19200	
	Interest on Loan:	160		**Less unearned**	**9600**	**9600**
	+ Outstanding:	**160**	320	Provision for Bad debts:		
	Advertisement:		11200	Old Provision:	5000	
	Salaries		27440	Less Bad debts:	2400	
	Depreciation on Building		438		2600	
$64578 \times \frac{5}{105}$	**Loss by fire**		20,000	**Less:** New		
	General Manager's			Provision:	1540	1060
	Commission at 5 %		3075			
	Net Profit (Transferred to					
	Capital)		61503			
			126648			126648

BASHIR & SONS
BALANCE SHEET
as at 31.12.1991

Assets		Rs.	Liabilities			Rs.
Current Assets:			**Current Liabilities:**			
Cash in hand		19194	**Unearned apprentice fee:**			9600
Sundry Debtors:	33200		**Interest on Loan**			160
Less Bad debts:	2400		Bank Loan at 5 %			6400
	30800		Works manager commission			2312
Less Provision for			General Manager			
doubtful debts:	1540	29260	Commission:			3075
Closing Stock		40,000	Creditors			21600
Accrued Interest on			**Fixed Liabilities:**			
Loan to Mr. X		194	Capital:		63200	
Loan to Mr. X		7760	**Less: Drawings:**	**10,000**		
Fixed Assets:			**+ Goods**			
Furniture		20,000	**drawn:**	**3000**		
Plant & Machinery		11640	**+Income Tax:**	**1440**	**14440**	
Buildings:	14162				48760	
+ Addition to Building:	3200	17362	+Net Profit:		61503	110263
Leasehold Premises		8000				
		153410				153410

NOTE:

(1) Works Manager Commission is calculated in this Way:

$$115600 \text{ (G.P.)} \times \frac{2}{100} = 2312$$

(2) General Manager's Commission is calculated as follows

Net profit after charging commission was: 64578

and 5 % of net profit will be $= 64578 \times \frac{5}{105} = 3075$

This method is followed because commission was included in the net profit.

ILLUSTRATION NO. 10

The following is the Trial Balance of a firm for the year ending 31st March, 1990. The business of the firm is carried on by two partners X and Y, who share profits and Losses equally. You are required to prepare Trading and Profit and Loss A/c for the year ended 31.3.1990 and a Balance Sheet as at that date.

	Debit Rs.	Credit Rs.
Plant & Machinery	100,000	
Sundry Debtors	44500	
Sundry Creditors		15000
Bills Receivable	9000	
Bills Payable		4200
Purchases (adjusted)	75000	
Sales		220,000
Freehold Premises	41000	
Salaries	10,000	
Wages	12500	
Postage & Stationary	850	
Carriage Outward	850	
Carriage Inward	550	
Provision for doubtful debts:		800
Bad debts	500	
General expenses	2300	
Cash at Bank	4220	
Cash in hand	780	
Reserve fund		15000
X's Capital		41000
Y's Capital		41000
Closing Stock	34950	
	337000	337000

The following adjustments should be made:

1. Provision for Doubtful debts be increased by 5 %.
2. Wages included a sum of Rs. 2500, which has been paid for installation of machinery.
3. X draws a salary of Rs. 500 per month.
4. Depreciation on Plant & Machinery is 5 % p.a.
5. Outstanding salaries are Rs. 1000.

Solution:

TRADING AND PROFIT & LOSS A/C

Dr. **For the Year Ended 31.3.1990** **Cr.**

		Rs.		Rs.
Purchases (adjusted)		75000	Sales	220,000
Wages:	12500			
Less: Wrongly included:	2500	10,000		
Carriage Inward		550		
Gross Profit c/d		134450		
		220,000		220,000
Salaries:	10,000		Gross Profit b/d	134450
+ Outstanding	**1000**	11000		
Postage & Stationery		850		
Carriage Outward		850		
General Expenses:		2300		
Provision for doubtful debts:				
New Provision:	**2525**			
+ Bad debts	500			
	3025			
Less old provision:	800	2225		
Depreciation on Plant & Machinery		5125		
X's salary		6000		
Net Profit transferred to X's Capital		53050		
Net Profit transferred to Y's Capital		53050		
		134450		134450

$102500 \times \frac{5}{100}$

$500 \times 12 =$

BALANCE SHEET
as at 31.3.1990

Assets		Rs.	Liabilities		Rs.
Current Assets:			**Current Liabilities:**		
Cash in hand		780	Outstanding Salaries		1000
Cash at Bank		4220	Creditors		15000
Bills Receivable		9000	Bills Payable		4200
Debtors:	44500		**Fixed & Long – Term**		
– Provision for			**Liabilities:**		
doubtful debts:	2525	41975	Reserve fund:		15000
Closing Stock		34950	Capitals:		
Fixed Assets:			Y:	41000	
Plant & Machinery:	100,000		+ Net Profit:	53050	94050
+ Amount included			X:	41000	
in wages wrongly:	2500		+ Net Profit:	53050	
	102500		+ Salary:	6000	100050
Less depreciation:	5125	97375			
Freehold Premises		41000			
		229300			229300

NOTE:

(1) In this illustration, now provision for bad debts will not be calculated in the usual way $\left(44500 \times \frac{5}{100}\right)$. But it will be calculated in the following way;

Old Provision	=	Rs. 800
– Bad debts	=	500
Excess old provision	=	300
+ 5 % of debtors: $44500 \times \frac{5}{100}$	=	2225
New provision	=	2525

So, new provision will be Rs. 2525 but not Rs. 2225. Thus, whenever, the statement given in adjustment is increase provision **'by this amount or percentage'**, this method will be followed to calculate new provision for doubtful debts. When new provision (Rs. 2525) is found out, we can apply by same formula to determine the amount, which should be charged to P & L A/c.

2. Opening Stock is not given in Trial Balance, closing stock is given in Trial Balance instead of giving as an adjustment. It means – the given purchases are **"adjusted purchases"**. In such case, closing stock will not be shown in Trading A/c; it will only be shown on the asset side of Balance Sheet.

QUESTIONS

1. What do you mean by "Adjustments"? Why it is necessary to make adjustments at the end of the accounting year?
2. Enumerate various adjustments which are generally made in the books of accounts on the last date of accounting period.
3. Given adjusting entries for the following:-

   (a) Closing stock; (b) Outstanding expenses; (c) Accrued revenue;

   (d) Un–earned revenue; (e) Prepaid expenses; (f) Interest on Capital
4. Show how provision for doubtful debts is created? Why is it necessary? How it is affected by the occurrence of bad debts? How it appears in the Balance Sheet?
5. Is it necessary to pass double entry for every adjustment? If so, why?
5. What do you mean by "Bad debts" and "Doubtful Debts"? Distinguish between the two.

PROBLEMS

1. **The balance of provision for Doubtful Debts A/c on 1.1.1990 was Rs. 2200. The bad debts during the year amounted to Rs. 1800. On 31.12.1990 the total balance of Debtors Account was Rs. 37000. The provision for doubtful debts is to be raised to 6 %.**

Req: Show the journal entries, ledger accounts and profit and loss A/c.

Ans: *[New provision Rs. 2220; Debit to P & L A/c Rs. 1820]*

2. **The following particulars are available from the books of Mr. A;**

1990		**Rs.**
January 1:	**Provision for Doubtful Debts**	**1200**
Dec. 31:	**Bad debts**	**600**
Provision for Doubtful Debts to be made at 5 % Debtors on 31st Dec.		**20,000**

Req: Give necessary journal entries and ledger accounts. Also show how items will appear in Balance Sheet.

Ans: *[New provision Rs. 1000; Dr. to P & L A/c Rs. 400]*

3. **The credit balance of Provision for Doubtful Debts A/c on 1.1.1990 was Rs. 927. Total bad debts during the year were Rs. 1012. At the end of that year, Debtors were amounted to Rs. 25700 and a provision of 5 % was created for doubtful debts. In 1991 actual bad debts amounted to Rs. 800 only. At the end of year, 1991 it was decided to create a provision for doubtful debts for Rs. 100 only.**

   You are required to show the Provision for Doubtful Debts A/c for the above two years.

Ans: *[New Provision Rs. 1285; Dr. to P & L A/c Rs. 1370 (31.12.90)*
New Provision Rs. 100; Cr. to P & L A/c Rs. 385 (31.12.91)]

4. **From the following particulars prepare the relevant accounts including Balance Sheet for the years, 1987, 1988, 1989:**

	1987	1988	1989
	Rs.	Rs.	Rs.
Bad debts	400	800	200
Provision for Bad debts on Jan. 1:	2000	—	—
Bad debts recovered:	—	600	—
Sundry Debtors on 31st December:	70,000	30,000	42,100

Further bad debts Rs. 100 are to be written off in 1989. A provision for doubtful debts is to be raised @ 2 % of sundry debtors.

Ans: *[(1987) Cr. to P & L A/c Rs. 200; (1988) Dr. to P & L A/c Nil; (1989) Dr. to P & L A/c Rs. 540.*

5. **Prepare Trading Account and Profit and Loss A/c for the year ending 31st December, 1990 and a Balance Sheet as at that date from the Trial Balance and adjustments given below:**

	Dr.	Cr.
	Rs.	Rs.
Drawings	7000	
Capital Account		40,000
Opening Stock	27500	
Purchases	242500	
Sales		305000
Sundry Debtors asset A/R	40,000	
Sundry Creditors A/P		30250
Sales Returns	2500	
Carriage Inwards	3000	
Salaries	14000	
Rent, Rates, Taxes	7500	
Insurance	2000	
Machinery	25000	
Furniture	2500	
Cash in hand	1750	
	375250	375250

ADJUSTMENTS:

1. **Depreciate Plant & Machinery and Furniture at 10 % p.a.**
2. **Outstanding Salaries Rs. 1000.**
3. **Insurance paid in advance Rs. 250.**
4. **Maintain 5 % reserve for doubtful debts on Debtors.**
5. **Closing Stock was valued at Rs. 30,000.**

Ans: *[Gross Profit Rs. 59500: Net Profit Rs. 30500: Balance Sheet Total Rs. 94750]*

6. **From the following Trial Balance you are required to prepare Trading A/c and Profit & Loss A/c for the year ending 31st March, 1991 and a Balance Sheet as at that date.**

	Debit Rs.	Credit Rs.
Capital A/c		100,000
Plant & Machinery	160,000	
Purchases	120,000	
Sales		354000
Purchase returns		1500
Sales returns	2000	
Opening Stock	60,000	
Discount allowed	700	
Discount received		1600
Sundry Debtors (Accounts Receivable)	90,000	
Sundry Creditors (Accounts Payable)		50,000
Salaries	13600	
Wages	20,000	
Carriage Inward	1500	
Carriage Outward	2400	
Provision for Bad debts		1050
Rent, rates and Taxes	20,000	
Advertisements	4000	
Cash in hand	1800	
Cash at Bank	12000	
Bank charges	150	
	508150	508150

The following adjustments are required:

1. Closing stock valued at Rs. 70,000.
2. Depreciation on Plant & machinery at 6 % p.a.
3. Bad Debts provision to be maintained at Rs. 1000.

Ans: *[G.P. Rs. 222000; N.P. Rs. 173200; B/s Total Rs. 323200]*

7. Following is the Trial Balance of Mukhtar Trading Co. as on 31st December, 1991. You are required to prepare the Trading and Profit and Loss A/c of the business for the year ending 31st December, 1991 and a Balance Sheet as at that date:

	Debit Rs.	Credit Rs.
Opening stock	10,000	
Purchases and Sales	40,000	100,000
Sundry Debtors and Creditors	30,000	6500
Plant & Machinery	35000	
Freehold Premises	24000	
Bills Receivable	2000	
Salaries	5000	
Wages	6250	
Carriage Inward	325	
Carriage Outward	375	
Printing & Stationery	400	
Bad debts	500	
Provision for Bad debts		225
Trade expenses	750	
Cash at Bank	3000	
Cash in hand	250	
Capital		50,000
Bills Payable		1625
Insurance	500	
	158350	158350

Adjustments:

1. Outstanding wages Rs. 500
2. Prepaid Insurance Rs. 200
3. Write off depreciation at 5 % on Machinery
4. Create provision for discount on creditors at 3 %
5. Bad debts Provision to be adjusted to 2 % on Debtors
6. Allow interest on capital at 5 %
7. Closing stock valued at Rs. 15000.

Ans: *[G.P. Rs. 57925; N.P. Rs. 46170; B/s Total Rs. 107100]*

8. The following Trial Balance has been extracted from the books of a trader on 31st March, 1991. Prepare Trading and Profit and Loss A/c for the year ending 31st March, 1991 and a Balance Sheet as at that date:

	Debit Rs.	Credit Rs.
Opening Stock	115000	
Debtors	65000	
Horses and Carts	10000	
Purchases	300,000	
General Expense	26000	
Discount	1100	
Wages	150,000	
Salaries	40,000	
Traveling Expenses	10,000	
Carriage	5500	
Insurance	3000	
Commission	6500	
Rent	10,000	
Cash in hand	500	
Cash at Bank	54500	
Printing Charges	3400	
Repairs	2600	
Interest on Mortgage	2000	
Building	80,000	
Machinery	30,000	
Capital		211100
Sales		600,000
Mortgage		62000
Sundry Creditors		42000
	915100	915100

The following adjustments are required:

1. Rent Payable Rs. 600
2. Insurance prepaid Rs. 400
3. Reserve for discount 2.5 % both on debtors and creditors.
4. Depreciate Building 2.5 %, Machinery 5 % and Horses and Carts at 7.5 %
5. Stock on 31st March, 1991 Rs. 120000.

Ans: *[G.P. Rs. 149500; N.P. Rs. 39875; B/s Total Rs. 354525]*

9. From the following Trial Balance of Faisal & Co., you are required to prepare Trading and Profit and Loss A/c for the year ending 31st December, 1990 and a Balance Sheet as at that date:

	Debit Rs.	Credit Rs.
Opening stock	30,000	
Land and Building	25000	
Goodwill	20,000	
Plant & Machinery	27500	
Loose Tools	500	
Drawings & Capital	10,000	60,000
Bills Receivable & Bills Payable	2500	8000
Purchases and Sales	45000	125000
Carriage	500	
Salaries	14000	
Wages	12500	
Loan to Saleem & Co. at 10 % p.a.	1500	
Sundry Debtors & Creditors	20,000	30000
Cash at Bank	10250	
Cash in Hand	500	
Furniture	1000	
Returns	1250	1500
Bad debts	750	
Insurance	1750	
	224500	224500

Adjustments:

1. Stock on 31.12.1990 was valued at Rs. 20,000
2. Depreciation Plant & Machinery at 10 % and Building at 5 %
3. Outstanding wages Rs. 1000
4. Interest on Saleem & Co. Loan was due for one year
5. Prepaid Insurance Rs. 750
6. Provide 5 % on debtors for Bad debts and 2 % for discount

Ans: *[G.P. Rs. 56250; N.P. Rs. 35270; B/s Total Rs. 124270]*

10. From the following Trial Balance of Sohail & Co. you are required to prepare Trading and Profit and Loss A/c for the year ending 31st December, 1990 and a Balance Sheet as at that date:

	Debit Rs.	Credit Rs.
Land and Building	170,000	
Plant & Machinery	80,000	
Furniture & Fixtures	26000	
Opening Stock	80600	
Drawings and Capital	64000	280,000
Purchases and Sales	220,000	408000
Debtors and Creditors	60800	48000
Returns	12000	10,000
Loan from SBFC on 1.10.1990 @ 12 %		80,000
Wages & Salaries	53000	
Printing & Stationery	6200	
Bad Debts	8400	
Provision for doubtful debts		6760
Cash at Bank	51760	
	832760	832760

Adjustments:

1. Closing Stock was valued at Rs. 100,000
2. Depreciate, Land & Building at 2.5 %, Plant & Machinery at 10 % and Furniture & Fixtures at 5 %
3. Write off Rs. 4800 a bad debts from debtors
4. Maintain Reserve for doubtful debts at 8 %.

Ans: *[G.P. Rs. 152400; N.P. Rs. 119330; B/s Total Rs. 465730]*

11. From the following balances extracted from the books of a trader, Prepare Trading and Profit and Loss A/c for the year ended 31st December, 1991 and a Balance Sheet as at that date:

	Rs.		Rs.
Bills Payable	37400	Interest on Bank Loan:	6000
Sundry Creditors:	75560	Sales	398760
General Expenses	15160	Discount Received	11600
Legal expenses	840	Bills Receivable	10720
Cash at Bank	37960	Purchases:	234400
Capital	338400	Stock on 1.1.1991	127800
Buildings	80,000	Sundry Debtors	126400
Loan from bank @ 10 % p.a.	80,000	Carriage	7160
Provision for bad debts	4400	Sales returns	57200
Cash in hand	4800	Bad debts	5200
Discount allowed	17200	Rent, taxes etc.	22400
Salaries & Wages	107280	Plant & Machinery	118000
Purchases returns	32400		

Adjustments:

1. Write off further bad debts Rs. 6440
2. Provide 5 % on debtors for doubtful debts
3. Interest on bank loan outstanding is Rs. 2000
4. Closing stock was valued at Rs. 187680.

Ans: *[G.P. Rs. 192280; N.P. Rs. 19762; B/s Total Rs. 553122]*

12. From the following Trial Balance of Farooq & Co. prepare Trading and Profit and Loss Account for the year ended 31st March, 1989, and a Balance Sheet as at that date:

	Debit Rs.	Credit Rs.
Stock on 1.4.1988	100,000	
Drawings	48000	
Cash in hand	6440	
Cash at Bank	23200	
Purchases and Sales	522000	980,000
Returns	12000	8000
Capital		514000
Provision for Doubtful Debts		4000
Bills Receivable & Bills Payable	200,000	20,000
Carriage Inwards	30,000	
Plant & Machinery	240,000	
Furniture	14000	
Sundry Debtors & Creditors	280,000	184000
Coal, gas and water	6000	
Wages	50,000	
Import duty and clearing charges	6000	
Office rent	19200	
Printing & Stationery	4000	
Insurance	1600	
Carriage Outwards	24800	
Salaries	108000	
Factory rent	9600	
Sundry expenses	5160	
	1710000	1710000

The following adjustments are to be taken into account:

1. Allow interest on capital at 5 % p.a.
2. Closing stock valued at Rs. 200,000
3. Outstanding liabilities to be provided for salaries Rs. 19200 and for Factory rent Rs. 9600
4. Provision for doubtful debts to be adjusted to 2.5 % of Sundry Debtors after writing off Bad debts amounting to Rs. 16000.

5. Goods taken away by the proprietor for his private use Rs. 12000, for which no record has been kept.

6. Depreciate Plant & Machinery and Furniture at 10 %.

Ans: *[G.P. Rs. 454800; N.P. Rs. 203140; B/s Total Rs. 915640]*

13. The following Trial Balance was extracted from the books of Sheikh & Bros. on 31st December, 1990. You are required to Prepare Trading and Profit and Loss A/c for the year ending 31.12.1990 and a Balance Sheet as at that date:

Debit Balances	Rs.	Debit Balances	Rs.
Drawings	6000	Bad Debts	2050
Interest on Loan	225	Trade expenses	2400
Cash in hand	550	Sundry Debtors	34000
Cash at Bank	8750	Bills Receivable	3975
Furniture	9000	**Credit Balances:**	
Plant & Machinery	15000	Discount received	2550
Opening stock	30000	Sales (less returns)	164000
Purchases (less returns)	115500	Provision for Bad debts	1000
Manufacturing Wages	15000	9 % Loan (1.1.1990)	5000
Salaries	8650	Bills Payable	6250
Rent and Taxes	2400	Sundry Creditors	30000
Discount allowed	3400	Capital	49300
Repairs and Renewals	900		
Insurance	300		

Adjustments to be made:

1. Allow interest on Capital at 5 %
2. Insurance paid in advance to the extent of Rs. 150
3. Provision for Bad debts is to be maintained at 5 % on sundry debtors
4. Closing stock was valued at Rs. 59250
5. Depreciate Plant & Machinery at 10 % and Furniture at 15 %
6. The manager is entitled to a commission of 10 % on the net profit after charging such commission.

[G.P. Rs. 62750; N.P. Rs. 35350; B/s Total Rs. 126125]

14. **From the following Trial Balance of a trader; Prepare Trading and Profit and Loss Account for the year ending 31st March, 1989 and a Balance Sheets at that date:**

Debit Balances	Rs.	Credit Balances	Rs.
Stock on 1.4.1988	12000	Discount received	600
Drawings	5600	Commission	2000
Furniture	2400	Returns	8000
Bills Receivable	12000	Bad debts Provision	4000
Cash in hand	6000	Sales	60000
Purchases	48000	Bank o/d at 15 %	8000
Returns	4000	Creditors	7400
Establishment Charges	10000	Bills Payable	10000
Taxes and Insurance	2000	Capital	40000
Bad debts	2000		
Sundry Debtors	20000		
Investment	16000		
	140000		140000

Further information are:

1. Closing stock is valued at Rs. 18000
2. Interest Accrued on Investment Rs. 840
3. Commission amounting to Rs. 400 relating to the next year
4. Bad debts reserve is to be maintained at Rs. 4000
5. Depreciate Furniture at 10 %
6. Salaries Rs. 400 and Taxes Rs. 1600 are payable
7. Insurance prepaid is Rs. 200.

Ans: *[G.P. Rs. 22000; N.P. Rs. 7800; B/s Total Rs. 71200]*

Note: When both salaries and establishment charges are given as separate items, establishment charges should be shown on the Asset side of Balance Sheet. When only Establishment charges are given, they are regarded as Salaries.

15. From the following information, prepare Trading and Profit and Loss Account for the year ended 31st December, 1991 and a Balance Sheet as at 31.12.1991.

(a) closing stock has been valued at Rs. 38000 (b) One quarter of Insurance Premium falls in the next year (c) Loan to Mr. X carried 8 % interest per annum (d) Loan from Mr. Y carried 6 % interest per annum (e) Depreciation is charged on furniture at 10 % p.a. (f) Goods worth Rs. 2000 have been taken by the proprietor for his private use, which have not been recorded in books (g) Provision for Bad debts is maintained at 5 %.

Trial Balance as on 31.12.1991

Debit Balances	Rs.	Debit Balances	Rs.
Cash at Bank	34000	Returns Inwards	3200
Cash in hand	800	Loan to Mr. X	12000
Bad debts	2000	Rent	4800
Discount	2400	Credit Balances:	
Furniture	12000	Rent by sub–letting	2000
Goodwill	20000	Sales	294800
Wages	400	Discount	1200
Insurance	2400	Reverse for Bad debts	4000
Advertisements	12000	Liabilities for expenses	7600
Debtors	120,000	Rent Payable	400
Purchases	240,000	Loan from Mr. Y	20,000
Stock on 1.1.1991	24000	Returns Outwards	2000
Salaries	24000	Capital	160,000
Drawings	24000	Creditors	52000
Carriage Inward	4000		
Carriage Outward	2000		

Ans: *[G.P. Rs. 65200; N.P. Rs. 15960; B/s Total Rs. 231160]*

16. The following Trial Balance was extracted from the books of Salman & Sons on 31st March, 1990. You are required to prepare Trading and Profit and Loss Account for the year ended 31st March, 1990, and a Balance Sheet as at that date.

	Debit Rs.	Credit Rs.
Drawings	20,000	
Capital		248000
Purchases and Purchases returns	300400	1200
stock on 1.4.1989	92000	
Cash in hand	6920	
Bank Balance	45200	
Plant & Machinery	77200	
General Expenses	1680	
Printing Charges	3280	
Accounting fee	560	
Commission		6600
Investments purchased on 1.4.1989 @ 10 %	8000	
Interest received on investment		400
Sundry Debtors and Creditors	72000	59340
Wages	50,000	
Salaries	28000	
Income Tax	3200	
Discount allowed and received	12600	9200
Sales returns and Sales	1100	417900
Bills Receivable	6400	
Furniture	6100	
Rent, Rates and Insurance	8000	
	742640	742640

The following adjustments are to be made:

1. **Charge interest on Capital at 5 % p.a. and 3 % on drawings**
2. **stock on 13.3.1990 is Rs. 104000**
3. **Provide Rs. 10000 for Wages**
4. **Accrued rent is Rs. 1000**
5. **Charge 5 % depreciation on Plant & Machinery and 10 % on Furniture**
6. **Insurance to the amount of Rs. 400 relates to next year.**

Ans: *[G.P. Rs. 69600; N.P. Rs. 15210; B/s Total Rs. 322150]*

17. **The following balances have been extracted from the books of Shakeel Khan as on 31st December, 1990. From this, you are required to prepare Trading and Profit and Loss Account for the year ending 31st December, 1990, and a Balance Sheet as at that date:**

Debit Balances	Rs.	Debit Balances	Rs.
Drawings	10,000	Insurance	2400
Debtors	80,000	General expenses	14600
Interest on Mortgage loan	1200	Discount	1600
Cash in hand	400	Rent	6000
Stock on 1.1.1990	16000	Water & Electricity	10,000
Machinery	32000	Investment	20,000
Cash at Bank	10,000	**Credit Balances:**	
Buildings	48000	Dividend received	1000
Depreciation on Building	1000	Discounts	2400
Bad debts	2000	Returns	21200
Purchases	281200	Sales	441600
Sales Returns	29600	Provision for Bad debts	2800
Wages	40000	Loan on Mortgage	16000
Salaries	24000	Creditors	40000
Carriage	4000	Capital	133000
Factory expenses	24000		

Adjustments:

1. **Closing stock Rs. 21600**
2. $\frac{3}{4}$ **of rent relates to Factory**
3. **Depreciate Machinery at 10 %**
4. $\frac{4}{5}$ **of water and electricity relates to Factory**
5. **Investments market value on 31.12.90 is Rs. 21000**
6. **Raise provision for doubtful debts to 5 % of debtors**
7. **Factory manager commission is 1 % of Gross profit**
8. **General manager commission is 5 % on net profit after charging such commission**
9. **Accrued Dividends, Rs. 400.**

Ans: *[G.P. Rs. 77100; N.P. Rs. 24218; B/s Total Rs. 205200]*

Note: Investment should be valued at Book value as it is less than the market value.

18. **The following are the balance taken from the books of Afzal & Co. on 31st March, 1989. You are required to prepare the Trading and Profit and Loss Account income statement for the year ending 31st March, 1989 and a Balance Sheet as at that date:**

	Rs.		Rs.
Capital	73600	Bad debts	20
Salaries	12000	Buildings	19200
Stock on 1.1.89	60000	General expenses	1060
Drawings	22000	Purchases	150000
Sales	248000	Sales returns	5400
Rent & Rates	4550	Wages	7000
Loan from Bank @ 10 %	10000	Traveling	1600
sundry creditors	71000	Insurance	1200
Cash in hand	2180	Legal charges	210
Sundry Debtors	89780	Purchases returns	2600
Furniture	10000		
Machinery	20000		
Reserve for discount	1000		

The following adjustments are to be made:

1. Depreciate Furniture and Machinery at 10 % p.a.
2. Insurance is paid in advance to the extent of Rs. 200
3. Interest on Bank Loan is outstanding
4. Closing Stock is valued at Rs. 100,000
5. Reserve for discount is no longer required and is to be written back.

Ans: *[G.P. Rs. 128200; N.P. Rs. 104760; B/s Total Rs. 238360]*

19. From the following Trial Balance and adjustments, you are required to prepare Trading and Profit and Loss Account for the year ended 31st December, 1991 and a Balance Sheet as on 31.12.1991:

Debit Balances	Rs.	Debit Balances	Rs.
Plant and Machinery	225000	Cash at Bank	15900
Bills Receivable	15000	Cash in hand	2400
Sundry Debtors	151800	Closing stock	90000
Purchases (adjusted)	270000	**Credit Balances:**	
Buildings	150000	Capital	210000
Salaries	33000	Sundry Creditors	30000
Wages	43200	Bills Payable	15000
Postage & Telegrams	2250	Sales	695100
Carriage Inward	2250	Provision for Bad debts	1050
Bad debts	2850	Reserve	60000
Carriage Outward	3000		
General Expenses	4500		

Adjustments:

1. Salaries unpaid Rs. 27000
2. Charges 5 % interest on capital
3. Raise Bad debts provision to 2.5 % of debtors
4. Transfer 2.5 % of net profit to Reserve A/c
5. It was discovered in January, 1991 that the stock on 31st December, 1990 was over cast by Rs. 3000

Hint: Closing stock as on 31.12.1990 will be the opening stock of 1991. As "adjusted purchases" are given in Trial Balance, so opening stock is included (has been added) in purchases. So, overcastting of Rs. 3000 will be deducted from purchases in Trading A/c. On the other hand, due to overcastting of stock on 31.12.1990, pervious year's profit was more by Rs. 3000.

Ans: *[G.P. Rs. 382650; N.P. Rs. 289531; B/s Total Rs. 646305]*

20. From the following Trial Balance and adjustment, you are required to prepare Trading and Profit and Loss Account an Balance Sheet as on 31st March, 1990.

	Debit Rs.	Credit Rs.
Drawings	21100	
Plant & Machinery	57600	
Furniture & Fixtures	17940	
Capital Account		238800
Sundry Creditors		119260
Loan from YIPS @ 6 % p.a.		40000
Provision for Bad debts		5000
Cash in hand	6060	
Cash at Bank	37940	
Sundry Debtors (including X for dishonored bill for Rs. 2000)	124000	
Bills Receivable	19000	
Opening Stock	179360	
Purchases	513180	
Manufacturing wages	81940	
Returns Inwards	5560	
Sales		712860
Salaries	22000	
Rent, Rates and Taxes	11240	
Interest and Discount	11740	
Traveling expenses	3760	
Repairs and renewals	6740	
Insurance (including premium of Rs. 600 p.a. paid up 30.9.90	800	
Bad debts	7240	
Commission Received		11280
	1127200	1127200

The following adjustment are to be made:

1. Closing stock was valued at Rs. 257920
2. Allow 5 % interest on capital
3. Depreciate Plant & Machinery by 5 % and Furniture & Fixtures by 10 % p.a.
4. Commission earned but not received Rs. 1200
5. Interest on Loan for the last two months is unpaid
6. Write off half of X's dishonored bill as bad debts
7. Maintain a provision for bad debts at 5 % on debtors (excluding total amount of bill dishonoured)

Ans: *[G.P. Rs 190740; N.P. Rs. 120886; B/s Total Rs. 510186]*

21. The following Trial Balance was extracted from the books of Ali Bros. on 31st December, 1988. You are required to prepare Trading and Profit and Loss A/c and Balance Sheet as on 31.12.1988:

Debit Balances	Rs.	Debit Balances	Rs.
Drawings	20000	Salaries	16000
Purchases	180000	Bad debts	800
Bills Receivable	24000	Cash at Bank	4000
Furniture	12000	**Credit Balances:**	
Debtors	48000	Discount on purchases	4000
Plant & Machinery	60000	Dividends	1200
Sales Returns	3200	Interest Payable	2400
Insurance	1600	Salaries Payable	800
Opening Stock	80000	Bank overdraft	40000
Wages	32000	Provision for Bad debts	2000
Printing & Stationery	4000	Sales	320000
Depreciation on Plant &		Creditors	32000
Machinery	2000	Returns Outwards	1600
Investment in Shares	24000	Bills Payable	20000
General expenses	44000		
Prepaid Insurance	400	Capital	132000

Adjustments:

1. **Closing stock was valued at Rs. 120000**
2. **Wages included a sum of Rs. 8000 spent on furniture**
3. **Increase provision for Bad debts by 5 % on debtors**
4. **Closing stock included Rs. 12000 worth of goods received for which the invoices were not received**

Hint: Goods worth Rs. 12000 were already received and included in the closing stock, but the entry for purchase of goods was not made, so it will be added to purchases and sundry creditors.

Ans: *[G.P. Rs. 142400; N.P. Rs. 77600; B/s Total Rs. 296800]*

22. **From the following Trial Balance and adjustments, prepare Trading and Profit and Loss Account for the year ending 31st March, 1990 and a Balance Sheet as at 31.3.1990:**

Debit Balances	Rs.	Debit Balances	Rs.
Cash in hand	1500	Insurance	3600
Cash at Bank	6600	Office Rent	6000
Bills Receivable	15900	Productive Wages	64500
Furniture	30000	Manufacturing expenses	4500
Machinery	84000	Trade expenses	16200
Drawings	21600	**Credit Balances:**	
Stock on 1.4.1989	61500	Sales	421500
Purchases	204000	Accounts Payable	42900
Freight Inward	4500	Provision for Bad debts	3000
Accounts Receivable	70500	Bills Payable	12600
Printing & Stationery	5100	Capital	180000
Salaries	48000		
Factory rent	12000		

The following adjustments should be taken into account:

1. **Stationery unused on 31.3.1990 is Rs. 900**
2. **Closing stock valued at Rs. 81000**
3. **Write off Rs. 1500 as bad debts and increase the Provision for Bad debts by 5 % on Accounts Receivable**
4. **Depreciation Machinery by 5 % and Furniture by 10 %**
5. **On 29 February, 1990 a fire broke out and destroyed stock of the value of Rs. 30000. The stock was not covered by insurance.**

Ans: *[G.P. Rs. 181500; N.P. Rs. 62850; B/s Total Rs. 276750]*

23. **The following balances have been extracted from the books of a Pharmaceutical firm on 31.12.1991:**

	Rs.		Rs.
Drawings	2500	Goodwill	2500
Cash in hand	55	Plant & machinery	10000
Cash at Bank	1000	Traveler's Sample	1350
Sundry Debtors	7300	Purchases	85500
Stock on 1.1.1990	16000	Transportation Inward	750
Purchases Returns	2000	Wages – productive	11500
Commission received	300	Coal, gas, power	4500
Outstanding expenses	3400	Rent & Insurance	9950
Sundry creditors	15000	Salaries	17200
Capital of the firm	20500	Discount (Cr.)	900
Sales	144800	General expenses	4300
Sales returns	300	Traveler's commission	1445
Provision for Bad debts	300	Traveler's salaries	4550
Advertisements expenses	4000	Discount (Dr.)	2500

Adjustments:

1. **Closing stock is valued at Rs. 11500**
2. **There has been a loss of stock by fire on December 10th, 1991, to the extent of Rs. 10,000. The Insurance Co., admitted the claim for a loss of Rs. 6000.**
3. **Depreciate Plant and Machinery by 10 %**
4. **Depreciate Traveler's sapless by $33\frac{1}{3}$ %**
5. **Write off one half of advertisements expenses**
6. **Increase the Bad debts provision to Rs. 1000**
7. **Insurance is paid up to 1st March, 1992, the annual insurance premium is Rs. 600.**

Req: You are required to prepare the Trading and Profit and Loss A/c and Balance Sheet on 31.12.1991 from the above mentioned particulars.

Ans: *[G.P. Rs. 49750; N.P. Rs. 2955; B/s Total Rs. 39355]*

24. From the following particulars extracted from the books of two partners A and B who shared profit and losses equally, prepare Trading and Profit and Loss Account for the year ended 31.12.1990 and a Balance Sheet as at that date:

Debit Balances	Rs.		Rs.
Cash in hand	7176	Salaries	25260
Furniture	10500	Opening Stock	34200
Sales Ledger Balance Debtors	156000	A's Drawings	16000
Motor Car	66000	B's Drawings	8000
Purchases	435000	Rent, rates and Taxes	10800
Insurance paid on 1.10.1990	7200	Fuel & Power	19290
Cash at Bank	18600	Credit Balances:	
Machinery	72000	A's Capital	40000
Trade expenses	10000	B's Capital	20000
Carriage outward	2930	Sales	876000
Wages: (manufacturing)	70800	Purchase Ledger creditors	
Sales Returns	7800	Balance	66000
Freight Inwards	6120		
Printing & Stationery	18324		

The following adjustments are required:

1. Goods worth Rs. 6000 were distributed as free samples
2. Closing stock is valued at Rs. 105000
3. A sum of Rs. 3000 paid for correction of machinery is debited to wages account
4. Write off bad debts Rs. 6000 and make a provision for Bad debts at 5 % on remaining debtors New Pro 7500
5. Depreciate furniture and machinery by 10 % and Motor Car by 20 %
6. Commission of Rs. 10800 has been earned but not yet received
7. An amount of Rs. 30000 was borrowed from Asif on 1st July 1990 and it was returned on 31st December, 1990. However interest at 10 % p.a. still remains unpaid
8. A Bill Receivable Rs. 3000 not yet due was discounted on 25th December, 1990.

Ans: *[G.P. Rs. 416790; N.P. Rs. 315726; B/s Total Rs. 419226]*

25. **From the following particulars, prepare Trading and Profit and Loss Account for the year ending 31st December, 1991 and a Balance Sheet as on that date:**

	Rs.		Rs.
Building	165000	Accounts Receivable	60000
Furniture & Fittings	7500	Accounts Payable	47400
Capital on 1.1.1991	150000	Binding Machinery	13500
Opening stock	24000	Loan to Saleem at 10 %	15000
Bills Receivable	10500	Investment	9000
Bills Payable	7500	Advertisements	16500
Purchases	60000	Commission received	3600
Sales	240000	Drawings	9000
Sales Returns	4500	Salaries	24150
Purchase Returns	1200	Cash in hand	750
Royalty	10700	Cash at Bank	10500
Wages	10000	Interest on Saleem's Loan	900

Adjustments:

1. Closing stock was valued at Rs. 21000
2. Unearned Commission Rs. 2400
3. Allow interest on Capital at 5 %
4. Interest on drawings amounted to Rs. 240
5. Advertisement expenses paid in advance to the extent of Rs. 15000
6. Stock valued at Rs. 9000 destroyed by fire on 20.12.1991 but the Insurance Company admitted a claim of Rs. 6000 only and paid it in 1992.
7. The General Manager is entitled to a Commission of 10 % of the Net profit after charging such commission.
8. Included in sales is an amount of Rs. 30000 repressing goods on "sale or return basis" the customer still having the right to return the goods. The goods were invoiced charging a profit of 20 % on cost.
9. The closing stock included goods worth Rs. 3000 for which invoice had not been received, and so, not yet recorded.
10. Accrued interest on Saleem's Loan Rs. 600.

Ans: *[G.P. Rs. 154000; N.P. Rs. 109809; B/s Total Rs. 329350].*

26. **From the following Trial Balance of Farhan & Co., prepare Trading and Profit and Loss Account for the year ended 31st December, 1990 and a Balance Sheet as at that after taking into consideration the given adjustments:**

	Debit Rs.	Credit Rs.
Drawings	42600	
Machinery	69000	
Opening Stock	87600	
Purchases	600000	
Capital Account		255000
Sales		714000
Sales Returns	12600	
Purchases Returns		11400
Salaries	26400	
Printing & Stationery	19200	
Apprentice fee received		4800
Bank overdraft		8400
Bad debts	10200	
Account Receivable	192000	
Account Payable		60000
Provision for Bad Debts		6000
	1059600	1059600

Adjustments:

1. **Stock on 31.12.1990 was Rs. 102000**
2. **Increase Bad debts provision on Accounts Receivable to 5 %**
3. **Provide discount reserve on Account Receivables at 2 %**
4. **Depreciate Machinery by 10 %**
5. **Goods taken away by the owner for his personal use Rs. 2400**
6. **Machinery purchased for Rs. 6000 was wrongly included in purchases**
7. **Stock of stationery on 31.12.90 for Rs. 1800 wrongly included in closing stock**
8. **Apprentice fee to be adjusted for four years**
9. **Carriage paid to bring machinery Rs. 600 included in printing and stationery A/c.**
10. **Stationery purchased for Rs. 2400 included in salaries.**

Hint: No depreciation is necessary on additions to machinery made during the year unless date of purchase is given. Also ignore depreciation on the cost of carriage to bring machinery.

Ans: *[G.P. Rs. 133800; N.P. Rs. 67452; B/s Total Rs. 349452]*

NC

CHAPTER - 12

WORK SHEET

WORK SHEET

Throughout an accounting period, all the activities of accountants are confined merely to the Journalisation of transactions and their posting to the ledger accounts. But at the end of an accounting period they have to produce the results of there activities in the form of financial statements. The preparation of financial statements is preceded by the construction of trial balance, journalizing and posting of adjusting entries, journalizing and posting of closing entries. This procedure is complex enough that there are fair chances of committing errors. At this level of their knowledge students must be aware of the fact that both the journal and ledger are formal and permanent records; so any error must be avoided in these documents.

One way of avoiding errors in these permanent accounting records is to use the work sheet. A work sheet is a large columnar sheet of paper, especially designed to arrange in a convenient systematic form all the accounting data required at the end of the period. The work sheet is not a part of the permanent accounting record but it is a working paper of accountants, prepared by pencil. If an error is made on the work sheet, it may be erased and corrected much more easily than an error in the formal accounting records. The work sheet is designed in a manner that it minimizes the chances of errors to the maximum possible extent. It brings into light many types of discrepancies which otherwise might be entered in the journal and posted to the ledger accounts.

It must be remember that it is not necessary to write Rupee signs, decimal points or commas with the amounts entered on the work sheet. The satisfactory completion of work sheet provides considerable assurance that all the details of the end of period accounting procedures have been properly brought together. Work sheet also serves as the source from which formal financial statements are prepared and the adjusting and closing entries are made in the journal and then posted to the ledger.

PREPARING THE WORK SHEET

We may further proceed with the help of an illustrations .

ILLUSTRATION NO. 1

Saeed & Co. is a trading concern. Their trial balance and adjustments are given below:

		Dr. Rs.	Cr. Rs.
	Cash	**37080**	
	Accounts Receivable	**52320**	
	Notes Receivable	**24000**	
●	**Merchandise Inventory on 1.1.1991**	**31650**	
●	**Prepaid Insurance:**	**4800**	
●	**Prepaid rent**	**4395**	
●	**Store supplies**	**1650**	
	Furniture and fixtures	**13500**	
●	**Accumulated depreciation - furniture:**		**3000**

Office equipment		
Accumulated depreciation - office equipment	11700	
Accounts Payable		4500
Owner's Equity		28600
Drawings		96,000
Purchases	4500	
Sales:	180,000	
Sales Returns and allowances:		289200
Purchases Returns and allowances:	6000	
Freight Inwards and customs duty:		2500
Sales Salaries	5750	
Advertising expenses:	34200	
Delivery expenses:	3795	
Office expenses:	2850	
Office Salaries	3510	
Interest Income	3000	
		900
	424700	424700

ADJUSTMENTS:

1. **Merchandise Inventory on 31.12.1991 was 40,000.**
2. **Rent expired during the year Rs. 2800.**
3. **Insurance expired during the year Rs. 2500.**
4. **Outstanding Sales salaries Rs. 2100.**
5. **Interest Receivable Rs. 200.**
6. **Stores supplies inventory on 31.12.1991 was Rs. 650**
7. **Depreciate Furniture and Fixtures by 10% p.a. and office equipment by 20% p.a.**
8. **Write of uncollectibles at Rs. 600.**

The heading of the work sheet illustrated for Saeed & Co. consists of three parts: (1) The name of the business, (2) The title **work sheet,** and (3) The period of time covered. The form of work sheet has **an account title column and the money columns arranged in five pairs of debit and credit columns.** The main headings of the five sets of money columns are:

1. Trial Balance
2. Adjustments
3. Adjusted Trial Balance
4. Income Statement
5. Balance Sheet

These five sets of columns have been discussed below:

1. TRIAL BALANCE COLUMNS:

The trial balance data may be assembled directly on the work sheet form or they may be prepared on another sheet first and then copied on the work sheet form.

2. ADJUSTMENTS COLUMNS:

The students are advised to record the adjusting entries first on a separate sheet of paper before recording adjustments in the adjustment columns of work sheet. It will definitely make the procedure more simple for them. The adjusting entries for the adjustments given in the illustration are shown below:

ADJUSTING ENTRIES

		Rs.	Rs.
(a)	Merchandise Closing Inventory .... Dr.	40,000	
	Income Summary		40,000
(b)	Rent Expenses .... Dr.	2800	
	Prepaid Rent		2800
(c)	Insurance Expense .... Dr.	2500	
	Prepaid Insurance		2500
(d)	Sales Salaries Expenses .... Dr.	2100	
	Outstanding Sales Salaries		2100
(e)	Interest Receivable .... Dr.	200	
	Interest revenue		200
(f)	Store supplies Expense .... Dr.	1000	
	Store Supplies		1000
(g)	Depreciation Expense - Furniture & Fixture .... Dr.	1350	
	Accumulated Depreciation - Furniture & Fixture		1350
(h)	Depreciation Expenses - Office Equipment .... Dr.	2340	
	Accumulated Depreciation - Office Equipment		2340
(i)	Bad Debts Expense .... Dr.	600	
	Accounts Receivable		600

If the titles of some accounts in all adjusting entries are not included in the titles already appearing in the trial balance, they should be inserted below the trial balance totals in the title column. For example, in our illustration, the titles not appearing in the trial balance are ***Merchandise closing Inventory, Income Summary, Rent Expense, Insurance Expense, Outstanding Sales Salaries, Store Supplies Expense, Depreciation Expense - furniture, Depreciation Expense - Equipment and Bad debts expense.***

Both the debit and credit parts of an adjusting entry should be inserted on the appropriate lines before going on to another adjustment. The sequence of adjustments is not important, except that there is a time and accuracy advantage in following the order in which the adjustments are assembled.

3. ADJUSTED TRIAL BALANCE COLUMNS:

The amounts in the Trial balance columns are combined with the amounts in the adjustments column and extended to the Adjusted Trial Balance Columns. For example, the prepaid Rent in the debit column of Trial Balance is Rs. 4395 and in the Adjustments columns, it is in the credit column at Rs. 2800 (see adjusting entry), so the amount extended (written) in the debit column of Adjusted Trial balance will be Rs. 1595 (4395 - 2800).

The same procedure is continued until all the account balances have been extended to the Adjusted Trial balance columns. The Debit and Credit columns are then totaled to prove that no arithmetical errors have been made up to this point. Now, the Adjusted Trial Balance will be a complete source of information for the preparation of financial statements.

4. INCOME STATEMENT AND BALANCE SHEET COLUMNS:

The data in the Adjusted Trial Balance columns are extended to one of he remaining four columns. ***The amounts of asset, liabilities, capital, and drawings are extended to the Balance Sheet columns, and the revenues and expenses are extended to the Income Statement Columns.***

In our illustration, the first account listed is cash and the balance appearing in the original trial balance debit column and in Adjusted Trial Balance debit column is Rs. 37080. Cash is an asset, it is listed on the balance sheet on the asset column. The balance of Accounts Receivable is extended in similar fashion. The balance of Rs. 51720 (adjusted balance) is extended to the debit column of Balance Sheet. The same procedure is continued until all the balances in Adjusted Trial balance are extended to appropriate columns.

After all of the balances have been extended, each of the four columns is totaled. The net income or the net for the period is the amount of the difference between the totals of the two Income Statement Columns. If the credit column total is greater than the debit column total, the excess is the net income.

Keeping in view the above mentioned procedure the work sheet is prepared below:

SAEED & CO.

WORK SHEET FOR THE YEAR ENDED 31.12.1991

	Account Titles	Trial Balance		Adjustments		Adjusted Trial Balance		Income Statement		Balance Sheet	
		Dr.	Cr.	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.
1	Cash	37080				37080				37080	
2	Accounts Receivable	52320			(i) 600	51720				51720	
3	Notes Receivable	24000				24000				24000	
4	Merchandise Inventory 1.1.91	31650				31650		31650			
5	Prepaid Insurance	4800			(c) 2500	2300				2300	
6	Prepaid Rent	4395			(b) 2800	1595				1595	
7	Store Supplies	1650			(f) 1000	650				650	
8	Furniture & Fixture	13500				13500				13500	
9	Accu-Depreciation-Furniture & Fixture		3000		(g) 1350		4350				4350
10	Office Equipment	11700				11700				11700	
11	Accu-Depreciation Office Equipment		4500		(h) 2340		6840				6840
12	Accounts payable		28600				28600				28600
13	Owner's equity		96000				96000				96000
14	Drawings	4500				4500				4500	
15	Purchases	180000				180000		180000			
16	Sales		289200				289200		289200		
17	Sales Returns & Allowance	6000				6000		6000			
18	Purchases Returns & Allowance		2500				2500		2500		
19	Freight Inward & Customs	5750				5750		5750			
20	Sales Salaries Expenses	34200		(d) 2100		36300		36300			
21	Advertising Express	3795				3795		3795			
22	Delivery Expenses	2850				2850		2850			
23	Office Expenses	3510				3510		3510			
24	Office Salaries	3000				3000		3000			
25	Interest Income		900				900		900		
		424700	424700								
26	Rent Expense			(b) 2800		2800		2800			
27	Insurance Expense			(c) 2500		2500		2500			
28	Outstanding Sales Salaries				(d) 2100		2100				2100
29	Interest receivable			(e) 200		200				200	
30	Interest Revenue				(e) 200		200		200		
31	Store Supplies Expense			(f) 1000		1000		1000			
32	Depreciation Expense Furniture			(g) 1350		1350		1350			
33	Depreciation Expense Equipment			(h) 2340		2340		2340			
34	Bed debts Expenses			(i) 600		600		600			
35	Merchandising Inventory 31-12-91			(a) 40000		40000			40000	40000	
36	Income Summery				(a) 40000		40000				
				52890	52890	470690	470690				
								49355			49355
	Net Income							332800	332800	187245	187245

QUESTIONS

1. What is meant by work sheet?
2. Explain the different steps to be kept in mind while preparing the work sheet?
3. What are the advantages of preparing work sheet?

PROBLEMS

1. **The following balances are extracted from the books of Asif & Bros. for the year ended 31st December, 2000. You are required to prepare the work sheet for the year ended 31.12.2000.**

	Rs.
Merchandise inventory on 1.1.2000	**36000**
Purchases	**140,000**
Purchases discounts	**3000**
Purchases returns and allowances	**2500**
Sales 175000	
Sales discounts	**1200**
Sales returns and allowances	**1600**
Carriage inwards	**800**
Wages:	**1500**
Sales Salaries	**15000**
Advertising expenses:	**9600**
Utilities expenses:	**7000**
Insurance:	**950**
Rent, rates and taxes	**2300**
Commission to salesmen:	**1900**

The Merchandise inventory on 31.12.2000 was valued at Rs. 53000:

Ans: *[Net income Rs. 15650]*

2. The following Trial Balance was extracted from the books of Naeem & Sons on 31st March, 2000. From this you are required to prepare a work sheet for the year ended on 31.3.2000.

Trial Balance On 31.3.2000

	Dr. Rs.	Cr. Rs.
Cash	5000	
Account Receivable	9000	
Merchandise inventory on 1.4.1999	6000	
Plant and Machinery	24000	
Land and Building	82000	
Furniture and Fixtures	2600	
Capital:		136000
Accounts payable		3800
Purchases:	60,000	
Purchases returns and allowances		2200
Discount on purchases:		600
Sales:		70,000
Sales returns and allowances	3000	
Sales Discount	1600	
Insurance prepaid:	3400	
Advertisement expenses	4000	
Salaries expenses:	12000	
	212600	212600

ADDITIONAL INFORMATION:

1. Prepaid insurance on 31.3.2000 is Rs. 1400
2. Outstanding salaries Rs. 1000.
3. Depreciation on plant and machinery @ 10% p.a.
4. Merchandise inventory on 31.3.2000 was valued at Rs. 6000.

Ans: *[Net loss Rs. 13200]*

3. Following is the Trial Balance of a firm. From this you are required to prepare a work sheet for the year ending on 31st December, 2000.

Trial Balance On 31.12. 2000

	Dr. Rs.	Cr. Rs.
Cash at Bank	80,000	
Accounts receivable	35200	
Stores supplies	5000	
Prepaid Rent	11240	
Furniture and Fixtures	7600	
Accumulated depreciation- Furniture and Fixture		1520
Prepaid Insurance:	8500	
Plant a Machinery	45000	
Accumulated depreciation - plant and Machinery		9000
Capital:		165000
Accounts payable:		8500
Drawings	31000	
Sales revenue:		212980
Salaries expense	9500	
Advertising expense	7000	
Purchases:	95000	
Wages:	10,000	
Purchases returns		6500
Sales returns	3000	
Merchandise Inventory on 1.1. 2000	45000	
Traveling expenses:	5460	
Miscellaneous expenses:	5000	
	403500	403500

ADJUSTMENTS:

1. Merchandise inventory on 31.12.2000 was valued at Rs. 35000.
2. Store supplies on hand 31. 12.2000 Rs. 1500.
3. Prepaid rent expired Rs. 9240.
4. Prepaid insurance expired Rs. 6000.
5. Depreciate furniture and fixture and plant and Machinery by 10% p.a.
6. Accrued salaries Rs. 3000.
7. Write off bad debts from accounts receivable Rs. 1500.

Ans: *[Net income Rs. 46020]*

4. From the following Trial Balance of Ahmad & Co., prepare a ten column Work Sheet for the year ended 31st December 1998:

Account Names	Debit Rs.	Credit Rs.
Cash in hand	15,000	
Accounts Receivables	42,500	
Furniture & Fixture	90,000	
Merchandise Inventory (1.1.1998)	60,000	
Goodwill	60,000	
Accumulated Depreciation		9,000
Accounts Payable		56,000
Bank Overdraft		27,500
Ahmad's Capital		95,000
Mortgage Loan		60,000
Sales less Returns		232,500
Commission Earned		12,000
Purchases Less Returns	145,000	
Wages & Salaries	35,000	
Rent Expenses	24,000	
Advertisement	18,000	
Misc. Expenses	2,500	
	492,000	492,000

ADJUSTMENTS:

1. Merchandise Inventory on December 31, 1998 was Rs. 105,000.
2. Depreciation on furniture @ 10 % p.a.
3. Wages outstanding Rs. 5000.
4. Rent unexpired Rs. 6000.
5. Commission earned but not received Rs. 3000.

Ans: *[Net Income Rs. 60,000 B/S Rs. 321500]*

5. The following is the trial balance of Butt Traders as on 31st March 1998:

Account Names	Debit Rs.	Credit Rs.
Capital		200,000
Drawings	20,000	
Bank Loan		75,000
Accounts Payable		39,000
Notes Payable		14,000
Cash in hand	35,000	
Investment	80,000	
Trade Mark	25,000	
Accounts Receivable	70,000	
Sundry Fixed Assets	1,15,000	
Merchandise Inventory (1.4.1997)	55000	
Purchases	140,000	
Freight Inward	8,000	

Insurance	20,000	
Prepaid Rent	30,000	
General Expenses	2,000	
Sales		265,500
Interest on Investment		6,500
	6000,000	600,000

ADJUSTMENTS:

1. Rent expired during the year was Rs. 12000.
2. Interest accrued Rs. 1500.
3. Write off irrecoverable Rs. 3500 from Account Receivables.
4. Merchandise Inventory on 31st March 1988 was Rs. 75000.
5. Depreciation on fixed assets 10 % p.a.

Required: A work sheet for the year ended March 31, 1998.

Ans: *[Net Income Rs. 96500 B/S Rs. 424500]*

6. Given bellow is the trial balance of Saleem & Co. as on 31st December 1998:

Account Names Rs.	Debit Rs.	Credit
Plant & Machinery	80,000	
Accounts Receivable	60,000	
Accounts Payable		73150
Merchandise Inventory Beginning	65,000	
Unearned Commission		16,400
Capital		129,000
Office Supplies	14,000	
Cash at bank	22,500	
Office Equipment	45,000	
Trade Expenses	17,000	
Sales Salaries	25,000	
Discount & Interest	7,500	
Sales		218,650
Purchases	130,000	
Octroi Duty	5,000	
Rent & Rates	18,000	
Allowances for uncollectibles		6,800
Loan from HBL		45,000
	489000	489000

ADJUSTMENTS:

(i) Merchandise Inventory at the close of period was Rs. 70,000.
(ii) Commission unearned Rs. 9000.
(iii) Allowance for uncollectible is maintained at 5 % on Accounts Receivable.
(iv) Good taken by Mr. Saleem for personal use amounting to Rs. 5000.
(v) Office Supplies on hand Rs. 10,000.

Ans: *[Net Income Rs. 33,350 B/S Rs. 292.500]*

7. The following Trial Balance has been extracted from the books of Usman Bros. for the year ended on 31st December, 1998:

NAME OF ACCOUNTS	Debit Rs.	Credit Rs.
Cash in hand	435	
Prepaid advertisement	2,790	
Office Furniture	25,400	
Accumulated Depreciation		1200
Capital		30,000
Drawings	2,600	
Accounts receivable	29,500	
Accounts Payable		8,500
Allowance for uncollectible		650
Supplies Expenses	1,450	
Sales		78,750
Salaries	9,850	
Purchases	34,980	
Sales Return	250	
Transporting Expenses	1,745	
Commission	2,280	
Dividend Received		980
Office Rent	8800	
	120,080	120,080

(i) Closing Inventory was valued at Rs. 14000.

(ii) Advertisement prepaid Rs. 1790.

(iii) Accrued dividend Rs. 120.

(iv) Allow interest on capital @ 5 % p.a.

(v) Make an allowance for uncollectible Rs. 780.

(vi) Rent outstanding Rs. 1200.

Ans: *[Net Income Rs. 30,665 B/S Rs. 73,845]*

8. From the following balances prepare ten columns work sheet for the year ended 31st December 1998:

	Dr.	Cr.
Drawings	5,275	
Accounts Receivable	44,500	
Land & Buildings	50,000	
Plant & Machinery	42,000	
Wages Productive	5,620	
Opening Inventory	69,680	
Traveling Expenses	9,750	

Prepaid Insurance	950	
Repair & Renewal	1,430	
Interest on Overdraft	2,050	
Uncollectibles	1,240	
Salaries	14,800	
Capital		114,500
Bank Overdraft		56,935
Sales		189,000
Commission		5,500
Accounts Payable		31,000
Purchases	149,640	
	396935	396935

1. Closing Inventory Rs. 102,000.
2. Write off Rs. 500 as Uncollectibles and make an allowance at 5 % on account receivable for uncollectibles.
3. Commission unearned Rs. 1500.
4. Interest on Drawings Rs. 725.
5. Interest on overdraft outstanding Rs. 450.
6. Insurance expired during the year was Rs. 300.

Ans: *[Net Income Rs. 38065 B/S Rs. 244650]*

9. The following trial balance has been extracted from the books of Riaz & Co. for the year ended on 31st December 1998:

ACCOUNT NAMES	Debit	Credit
Cash at bank	3950	
Accounts Receivable	64,340	
Merchandise Inventory	50,800	
Prepaid Rent	4,650	
Store Supplies	7,000	
Furniture & Fixture	18,000	
Office Equipment	42,000	
Accounts Payable		43,500
Owners Equity		1,10,000
Drawings	10,000	
Sales		165,550
Purchases	105,635	
Purchases Returns		1,435
Sales Returns	1,450	
Delivery Expenses	3,500	
Office Expenses	6,000	
Accumulated Depreciation		21,290
Freight Inward	2,850	
Office Salaries	21,600	
	341,775	341,775

ADJUSTMENTS:

1. **Closing Inventory on 31.12.1998 was Rs. 75,000.**
2. **Prepaid Rent Rs. 1450.**
3. **Store supplies inventory on 31.12.1998 was Rs. 2500.**
4. **Depreciate furniture by 10 % and office equipment by 20 % p.a.**
5. **Allowances for uncollectible at Rs. 3400.**

Required: Prepare a work sheet.

Ans: *[Net Income Rs. 28,850 B/S Rs. 217,240]*

10. The following trial balance has been extracted from the books of Khurram Bros. for the year ended 31st December 1998. Prepare work-sheet for the year ended 31st December 1998:

ACCOUNT NAMES	Debit	Credit
Closing Inventory	40,000	
Purchases (adjusted)	143,450	
Sales		234,000
Accounts Receivable	70,000	
Accounts Payable		47,000
Marketable Securities	25,000	
Building	80,000	
Machinery	50,000	
Cash at Bank	4,950	
Freight Inward	1,490	
Packing Expenses	4,800	
10 % Loan		80,000
Owner's Equity		115,000
Drawings	5,000	
Depreciation on Building	1,600	
Depreciation on Machinery	1,000	
General Expenses	12,640	
Advertisement	8,900	
Establishment Charges	26,000	
Insurance	5,000	
Rent Recovered		3,830
	4,79,830	4,79,830

ADJUSTMENTS:

1. **Insurance paid up to 31st March 1999.**
2. **Rent recoverable Rs. 1170.**
3. **Interest on loan outstanding for six months.**
4. **Goods costing Rs. 6500 spoiled due to fire, insurance company admit a claim of Rs. 4000.**
5. **Allowance for uncollectible at 5 % on Account Receivable.**

Ans: *[Net Income Rs. 31,870 B/S Rs. 281,370]*

NC

CHAPTER - 13

FINANCIAL STATEMENTS

FINANCIAL STATEMENTS

Financial information is conveyed to users in a variety of reports (statements) and schedules. There are so many parties who are interested in these reports, e.g. owner, management, creditors, research scholars, Government authorities etc. Generally, reports to internal users (management) are specially designed to meet their particular needs. Reports to external users tend to be more standardized and are often referred to as "**Financial Statements**". Traditionally, two principal statements are prepared for business concerns:-

(a) An income statement (Trading a Profit and Loss A/c) which is prepared to ascertain the net income (net profit) or net loss of the business for a specific accounting period and

(b) *A balance sheet, which is* prepared to know the financial position of a business on a particular date.

INCOME STATEMENT:

An income statement shows the results of operating for a period of time. It is sometimes called an operating statement or statement of operations, It shows how well an organisation performed during the period covered.

The terms, revenue, expense and profit should be somewhat familiar to you already. *Revenue* is the inflow of assets in return for services performed or products delivered during a period; an *expense* is a sacrifice, or cost, incurred to generate (produce) revenue; *net profit* is simply the amount by which the revenues for a particular period of time exceed the expenses incurred to generate them.

Revenues generally considered earned when services are performed or goods are sold, regardless of when money is actually received. In other words, revenues are identified with the period in which they are earned. For example, a retail trader earns 'revenue' when a sale is made on credit. A right to receive money is recongnized as an "*account receivable*". An account receivable (Debtor A/c) is an asset that will eventually be converted to cash.

Expenses are also recognized in the period that is benefited, regardless of when payment is made in cash. For example, salaries earned by employees are considered an expense of the period in which employees work, even though they may not be paid in cash until the following period.

Thus the amount by which the revenues for a particular period of time exceed the expenses incurred to generate them is called net income (net profit).

For example suppose during the month of January, a trader has a total revenue (sales) of Rs. 55,000 and has incurred total expenses of Rs. 46000, his net income will be Rs. 9000 (55000-46000) for the month of January.

Thus an income statement is a statement in which revenues for a period of time are matched with expenses for the same period of time. If revenues exceed the expenses, the result is *net income*, and if expenses exceed the revenues, the result is *net loss*.

The format of an income statement varies with the needs of users, preferences of accountants and other circumstances. The format of a common income statement is given below.

NAME OF BUSINESS
INCOME STATEMENT
for the year ended........

	Rs.	Rs.	Rs.	Rs.
Sales			525000	
Less: Sales Discounts		6500		
Sales returns & allowances		8500	15000	
Net sales				510,000
Less cost of goods sold:				
Merchandise inventory (opening)			35000	
Purchases		320000		
Less: Purchase discounts	5000			
Purchase returns & allowances	3000	8000		
Net Purchases		312000		
Plus: Carriage Inwards		12500		
Delivered cost of net purchases			324500	
Cost of goods available for sale			359500	
Less Merchandise Inventory (closing)			37500	
Cost of goods sold				322000
Gross profit				188000
Less operating expenses:				
Salaries			91600	
Advertising			7000	
Depreciation			8500	
Total operating expenses				107100
Net operating income:				80900
Plus: other revenue:				
Commission received				2500
				83400
Less other expenses: interest:				900
Net income:				82500

DIFFERENT ITEMS OF INCOME STATEMENT

1. SALES:

It is the gross amount of goods sold or services performed during an accounting period.

2. NET SALES:

When sales discount, sales returns and allowances to customers are deducted or subtracted from sales (Gross Sales), the result is '*net sales*'.

3. COST OF GOODS SOLD:

It represents the sum of the costs of all goods which have been sold during the accounting period. It is ascertained by adding the value of unsold goods at the beginning of the year (opening inventory or stock) to the purchases made during the year and the deducting the values of unsold goods at the end of the year (closing inventory or stock) from the purchases. These are expired costs, and thus are actually expenses for the year.

It must be noted that purchases price of goods includes not only the cost price of goods but also all expenses connected with the purchases, such as freight inwards carriage, wages, customs duty etc. These expenses are collectively known as Direct Expenses. In determining cost of goods sold net purchases are taken into account. When all direct expenses are added to the purchase price of goods and purchases returns are deducted from purchases, the result is *net purchases*:

So, the schedule of cost of goods sold will be as follows;

COST OF GOODS SOLD:

Merchandise Inventory (goods) opening		xx
Add: Purchases	xx	
Less returns & allowances and discount	xx	
	xx	
Add: Direct expenses:	xx	xx
Cost of goods available for sale		xxx
Less: Merchandise Inventory (closing)......		xx
Cost of goods sold:		xx

For example, suppose:

(a)	Merchandise inventory on 1st Jan. 1991 was	Rs. 9100
(b)	Purchases during the year, 1991	Rs. 170,000
(c)	Purchases returns.	Rs. 2000
(d)	Purchases discount and allowances:	Rs. 1000
(e)	Transportation inwards	Rs. 5000
(f)	Customs duty etc.	Rs. 7000
(g)	Merchandise Inventory on 31st December, 1991	Rs. 10300

The cost of goods sold will be determined in the following way:

Merchandise inventory on 1.1.1991		Rs. 9100
Add purchases.....	170,000	
Less purchases returns:	2000	
	168000	
Less Purchases discount and allowances.	1000	
	167000	
Add: Direct expenses (5000 + 7000)	12000	179000
Cost of goods available for sale		188100
Less Merchandise inventory on 31.12.1991		10300
Cost of goods sold....		177800

4. GROSS PROFIT:

Merchandisers (Traders) naturally try to sell goods at a price more than the cost price. *Gross profit or gross margin,* is what remains after cost of goods sold is deducted from net sales. This is the margin that is available to cover the other expenses for a period and to yield net income, if there is any.

G.P = Net sales -- Cost of goods sold:

5. OPERATING EXPENSES:

Merchandising (Trading) concerns incur operating expenses in addition to cost of goods sold. So, the expenses which are incurred for the generation of revenues from the sales of goods are called *Operating expenses.* Operating expenses may be divided into two:

(a) Selling Expenses:

All expenses regarding sale of goods and sending them to the buyers belong to this class. e.g. Carriage outwards, Advertisements, Salesmen's Salaries, Salesmen's Commission, Travelling Expenses, Bad debts, Packing expenses etc.

(b) Administrative Expenses:

All expenses connected with the office and its conduct are called 'Administrative expenses' e.g., office salaries, office rent, electric charges, postage & Telegrams, Telephones, Printing & Stationery etc.

6. NET OPERATING INCOME:

Operating expenses are deducted from gross profit to arrive at net operating income. Net *operating income* is what is left after both cost of goods sold and operating expenses for a period have been deducted from net sales. For a merchandising concern, it is what has been earned from the normal operations of buying and selling merchandises.

Net operating Income = Gross profit - Operating expenses.

Or Net operating Income = Net sales - Cost of goods sold - Operating expenses:

7. OTHER REVENUES AND EXPENSES:

Non-sales revenues (which have not been earned by selling merchandise) and non-operating expenses are reported towards the bottom of an income statement under the heading, *other revenues and expenses.* Included in other revenues are revenue from rentals (rent received), Interest income (interest received), gain on sales of assets other than merchandise and other miscellaneous revenue items. Under other expenses are interest on borrowed money, losses on sales of assets other than merchandise, and other non-operating expenses and losses.

8. NET INCOME:

Other revenues are added to and other expenses are deducted from, net operating income to arrive at net income. N*et Income* is what is left after the other revenues have been added to net operating income and other expenses have been deducted from it.

Net Income = Net operating income + other revenues - other expenses

Or Net Income = Net Sales - Cost of goods sold - operating expenses

+ other revenues - other expenses.

SERVICE ENTERPRISES:

Service enterprises are the business concerns which are engaged to perform or provide services only. They do not deal with the purchase and sale of merchandise (goods). Their major source of revenue is fees, commission, rent or interest etc. which they receive from their customers or clients against the services provided to them. For example, Dectors, Lawyers, chartered firms, workshops etc.

The income statement for a service enterprise is prepared in the same way as we prepare for merchandising concerns except that the nature of revenues and expenses is different.

BALANCE SHEET:

Balance sheet shows the financial position or condition of an organisation at a particular point in time. In fact, it is sometimes referred to as a *position statement or a statement of condition.*

It shows the economic resources (properties, possessions) of an organisation, referred to as assets, and the claims that creditors and owners have against the assets. Economic obligations of an organisation (amount owed to creditors) are called *liabilities,* and owners' claims are referred to as *owners' equity, or capital,*

A common arrangement of the balance sheet is to list assets on the left side and liabilities and owner's equity on the right. This balances arrangement, with assets and equities (liabilities) side by side, is sometimes referred to as the *account form of balance sheet,* because it resembles the traditional T-form of an account.

An alternative arrangement, sometimes called the report form of balance sheet, centres the asset section under the heading, with the equity claims shown below the asset. The report form frequently fits on a standard sheet of paper better than the account form.

You may recall that assets are normally listed on a balance sheet in the order of their relative nearness to cash. For example, the Accounts Receivable (Sundry Debtors) account usually follows the cash account because the accounts receivable are likely to turn into cash very soon. On the other hand, assets like Land and Buildings are normally listed towards the end, because they are expected to be around a long time. So, the balance sheet that divides its accounts into subgroups within the major sections of the statement is called, *a classified balance sheet.* Generally assets are divided into two groups, current and non-current. Current assets are cash and other assets that are relatively close to being cash. In practice, an asset is classified as current if it can meet any of the following conditions within the year:

(a) If it can reasonably be expected to turn into cash.

(b) If it can easily be converted to cash by the managers of the entity.

(c) If it can take the place of cash (as with prepaid expenses).

When assets are divided into current and non-current groups, it is common practice to classify liabilities in a similar way. *Current liabilities* are liabilities that can reasonably be expected to be paid within one year. Naturally, the liabilities that are not expected to be paid within one year are referred to as *non-current liabilities*:

The format of a Balance Sheet in report form is given below:

NAME OF BUSINESS...

Balance sheet as at...

	Rs.	Rs.	Rs.
Assets:			
Current:			
Cash		2580	
Accounts receivable		2180	
Supplies		1520	
Total current assets:			6280
Non current:			
Land		6000	
Building	48000		
Less: accumulated depreciation	14800	33200	
Total non-current assets			39200
Total Assets			45480
Liabilities			
Current:			
Accounts payable and interest payable:	790		
Wages Payable:	50		
Total current Liabilities			840
Non-Current and owner's Equity			
Notes Payable (Bills Payable)		10000	
Owner's equity (capital):		34640	44640
Total liabilities and owner's equity.			45480

DIFFERENCE BETWEEN INCOME STATEMENT AND TRADING AND PROFIT AND LOSS ACCOUNT:

Both income statement and trading and profit and loss account are prepared to ascertain the net result of the business concerns. Some business concerns who have adopted British Accounting System, prepare Trading and profit and loss account to determine the net results of the business, while some others who have adopted American Accounting System, prepare income statement for the same purpose. Different terms are used under the two systems of accounting. Some American terms are given below which are equivalent to British terms.

British Accounting System		American Accounting system
1.	Bad Debts	Uncollectable accounts
2.	Provision for doubtful debts	Allowances for doubtful accounts
3.	Sundry Debtors	Accounts Receivable
4.	Sundry Creditors	Accounts payable
5.	Closing Stock of goods	Closing inventory of Merchandise
6.	Opening stock of goods	Opening inventory of Merchandise
7.	Gross profit	Gross income
8.	Net profit	Net income
9.	Trading and profit and loss A/c	Income statement
10.	Bills receivable	Notes Receivable
11.	Bills payable	Notes payable
12.	Capital	Owner's equality
13.	Income	Revenue
14.	Purchases on credit	Purchases ona ccount
15.	Company	Corporation.

EFFECT OF ADJUSTMENT ON FINANCIAL STATEMENTS

Now a days majority of the business enterprises are preparing their financial statements in statement form. The adjustments and their effect on final accounts have been discussed in detail in chapter No.11. Now in this chapter effect of adjustments on income statement is discussed to meet the requirements of modern business.

1. OUTSTANDING EXPENSES: OR ACCRUED EXPENSES:

(a) If the outstanding Expenses are non-recurring i.e., direct expenses:

Outstanding Expenses

Added to Net Purchases in cost of goods sold schedule in income statement

Shown in the Balance sheet under the head of current liabilities

Look at the Income Statement given below:

INCOME STATEMENT

			Rs.	Rs.	Rs.
COST OF GOODS SOLD:					
	Net purchases		×××		
Add:	Wages	××			
"	Outstanding wages	××	×××		

(b) If the outstanding expenses are recurring i.e. operating expenses:

Outstanding Expenses

Deducted from Gross Income under the head of operating expenses in income statement	Shown in the Balance sheet under the head of current liabilities

Look at the income statement given below:

INCOME STATEMENT

		Rs.	Rs.	Rs.
OPERATING EXPENSES:				
Office & Administration Expenses:				
Salaries	××			
Add: Outstanding Salaries	××	×××		

2. PREPAID EXPENSES OR UNEXPIRED EXPENSES OR EXPENSES PAID IN ADVANCE:

Unexpired Expenses

Expenses expired are deducted from Gross Income under the head of operating expenses in Income Statement.	Unexpired expenses are shown in the Balance Sheet under the head of current assets.

INCOME STATEMENT

		Rs.	Rs.	Rs.
OPERATING EXPENSES:				
Office & Administration Expenses:				
Rent Expired	××			

3. ACCRUED REVENUE OR REVENUE RECEIVABLE:

Accrued Revenue

Added to Operating Income under the head of Other Revenues in Income Statement	Accrued revenue is recorded as current asset in Balance Sheet.

INCOME STATEMENT

	Rs.	Rs.	Rs.
OPERATING INCOME:			× × ×
Add: **Other Revenues**			
Rental Revenue		× ×	
Add: Accrued Rental Revenue		× ×	× × ×

4. UNEARNED REVENUE OR REVENUE RECEIVED IN ADVANCE:

Unearned Revenue

Revenue earned is added to operating income under the head of other Revenues in Income Statement

Unearned revenue is shown in Balance Sheet under the head of Current Liabilities.

INCOME STATEMENT

	Rs.	Rs.	Rs.
OPERATING INCOME:			× × ×
Add: **Other Revenues:**			
Commission earned			× ×

5. DEPRECIATION OF ASSETS

Depreciation

Deducted from Gross Income under the head of operating Expenses in income statement

Shown under the head of Fixed Assets in Balance Sheet "as deduction from the concerned asset".

INCOME STATEMENT

	Rs.	Rs.	Rs.
OPERATING EXPENSES:			
Office & Administration Expenses:			
Depreciation on Buildings	× × ×		

Note: (i) If Depreciation Expense is given on debit side of Trial Balance then it is recorded only in Income Statement under the head of Office & Administration Expense.

(ii) If Accumulated Depreciation is given on credit side of Trial Balance then this balance is added in current year's depreciation and total balance is deducted from concerned balance sheet.

6. INTEREST ON CAPITAL:

Interest on Capital

- **Deducted from operating** income under **the head of Financial** & other expenses in **Income statement**
- Shown on the Liability side of Balance Sheet "as addition to capital"

INCOME STATEMENT

	Rs.	Rs.	Rs.
OPERATING INCOME:			×××
Less: **Financial & Other Expenses:**			
Interest on Capital			×××
			×××

7. INTEREST ON DRAWINGS:

Interest on Drawings

- Added to operating income under the head of other Revenues in Income Statement
- Added to Drawings and total Drawings are deducted from capital on Liability side of B/S.

INCOME STATEMENT

	Rs.	Rs.	Rs.
OPERATING INCOME:			×××
Add: **Other Revenues:**			
Interest on Drawings			×××
			×××

8. CLOSING INVENTORY:

Closing Inventory

- Deducted from cost of goods available for sales in income Statement
- Shown as current Asset in Balance Sheet

INCOME STATEMENT

	Rs.	Rs.	Rs.
COST OF GOODS SOLD:			
Cost of goods available for sale		× × ×	
Less: Closing Inventory		× ×	× × ×

Note: If closing Inventory is given in Trial Balance then it is recorded as a current asset only in Balance Sheet.

9. ALLOWANCES FOR UNCOLLECTIBLES:

Allowances for Uncollectibles

- In selling Expenses bad debts/ uncollectibles are added to Allowance for uncollectible required and from total balance existing Allowance for uncollectible is deducted.
- In Balance Sheet Allowance for uncollectible required is deducted from Accounts Receivables

INCOME STATEMENT

		Rs.	Rs.	Rs.
OPERATING EXPENSES:				
Selling & Distribution Expenses:				
Allowance for uncollectible required	× × ×			
Add: Uncollectibles given in T/B	× ×			
Add: Uncollectibles given in Adjustments	× ×			
	× × ×			
Less: Existing Allowance for uncollectibles	× ×			
		× × ×		

ILLUSTRATION NO. 1

From the following Trial Balance of Rehman and Sons, prepare an income statement for the year ended 31st December, 1990 and a balance sheet as at that date:

	Dr. Rs.	Cr. Rs.
Cash at Bank:	80000	
Accounts Receivable	250000	
Merchandise inventory on 1.1.1990	150,000	
Land	110,000	
Building	600,000	
Accumulated depreciation Building		220,000
Accounts payable		120,000
Notes payable (long-term)		200,000
Owner's Equity (capital)		290,000
Drawings	50,000	
Sales		2150,000
Sales Discounts	20,000	
Sales Returns and Allowances:	30,000	
Rent Revenue		50,000
Purchases:	1300,000	
Purchases Discounts		10,000
Purchases Returns and Allowances		20,000
Transportation Inwards	50,000	
Salaries expenses	350,000	
Advertising expenses	30,000	
Utilities expenses	40,000	
	3060000	3060000

ADJUSTMENTS:

1. Closing Merchandise Inventory was Rs. 70,000.
2. Depreciate Building by Rs. 20,000.

Solution:

REHMAN AND SONS

Income Statement

For the year ended 31st December, 1990:

	Rs.	Rs.	Rs.	Rs.
Sales			2150000	
Less: Sales discounts		20000		
Sales Returns and allowances:		30000	50000	
Net sales				2100000
Less Cost of goods sold:				
Merchandise inventory on 1.1.90			150000	
Purchases:		1300000		
Less: Purchase discounts	10000			
Purchases Returns and allowances	20000	30000		
Net purchases		1270,000		
Plus: Transportation Inwards		50000		
Delivered Cost of net purchases			1320000	
Cost of goods available for sale			1470000	
Less: Merchandise inventory 31.12.90			70000	
Cost of goods sold				1400000
Gross profit				700000
Less: operating expenses:				
Salaries			350000	
Advertising			30000	
Utilities			40000	
Depreciation			20000	
Total operating expenses:				440000
Net operating income				260000
Add: Other revenue				
Rent				50000
Net Income				310000

REHMAN AND SONS
BALANCE SHEET
as at 31.12.1990

	Rs.	Rs.	Rs.
Assets:			
Current:			
Cash at Bank		80000	
Accounts Receivable		250000	
Merchandise Inventory on 31.12.90		70000	400000
Non-current:			
Land		110000	
Building	600000		
Less-Accumulated depreciation	240000		
		360000	470000
Total Assets			870000
Liabilities:			
Current:			
Accounts Payable:			120000
Non-current:			
Notes payable (long-term)		200000	
Owner's equity:	290000		
Add net income	310000		
	600000		
Less: Drawings	50000		
Total owner's equity		550000	750000
Total liabilities and owner's equity:			870000

ILLUSTRATION NO. 2

The following Trial Balance has been extracted from the books of Saeed and Co. on 31.12.1991. From this, prepare an income statement for the year ended 31.12.1991 and a Balance Sheet as at 31.12.1991.

	Dr. Rs.	Cr. Rs.
Cash	37080	
Accounts Receivable	52320	
Notes Receivable	24000	
Merchandise Inventory on 1.1.1991	31650	
Prepaid Insurance:	4800	
Prepaid rent	4395	
Store supplies	1650	
Furniture and fixtures	13500	
Accumulated depreciation - furniture:		3000
Office equipment	11700	
Accumulated depreciation - office equipment		4500
Accounts Payable		28600
Owner's Equity		96,000
Drawings	4500	
Purchases	180,000	
Sales:		289200
Sales Returns and allowances:	6000	
Purchases Returns and allowances:		2500
Freight Inwards and customs duty:	5750	
Sales Salaries	34200	
Advertising expenses:	3795	
Delivery expenses:	2850	
Office expenses:	3510	
Office Salaries	3000	
Interest Income		900
	424700	424700

ADJUSTMENTS:

1. Merchandise Inventory on 31.12.1991 was 40,000.
2. Rent expired during the year Rs. 2800.
3. Insurance expired during the year Rs. 2500.
4. Outstanding Sales salaries Rs. 2100.
5. Interest Receivable Rs. 200.
6. Stores supplies inventory on 31.12.1991 was Rs. 650
7. Depreciate Furniture and Fixtures by 10% p.a. and office equipment by 20% p.a.
8. Create allowance for uncollectibles at Rs. 600.

Solution:

SAEED AND CO.
INCOME STATEMENT
for the year ended 31st December, 1991

	Rs.	Rs.	Rs.	Rs.
Sales Revenue (gross)			289200	
Less Sales Returns and allowances:			6000	
Net Sales Revenue				283200
Cost of Goods Sold:				
Merchandise inventory 1.1.1991		31650		
Purchases:	180000			
Plus: Freight and customs duty	5750			
Delivered cost of Merchandise		185750		
Less: Returns and allowances:		2500		
Cost of net purchases:			183250	
Cost of goods available for sale			214900	
Less: Merchandise inventory (closing)			40000	
Cost of goods sold				174900
Gross profit				108300
Operating Expenses:				
Selling expenses:				
Sales Salaries		34200		
Outstanding Sales Salaries		2100		
Advertising expenses		3795		
Delivery expenses		2850		
Allowance for uncollectibles:		600	43545	
General and Admn expenses:				
Office expenses:		3510		
Office salaries		3000		
Rent expense		2800		
Insurance expense		2500		
Stores supplies used		1000		
Depreciation - Furniture and Fixture		1350		
Depreciation - Office Equipment		2340	16500	
Total expenses:				60045
Net operating income				48255
Add: Other revenue: Interest				1100
Net Income				49355

SAEED AND CO.
BALANCE SHEET
as at 31.12.1991

	Rs.	Rs.	Rs.
Assets:			
Current:			
Cash		37080	
Accounts Receivable	52320		
Less: Allowance for uncollectible:	600	51720	
Notes Receivable		24000	
Marchandise inventory on 31.12.1991		40000	
Prepaid Insurance:		2300	
Prepaid Rent		1595	
Interest Accrued		200	
Store supplies inventory on 31.12.1991		650	
Total current Assets			157545
Non-Current:			
Furniture & Fixture	13500		
Less: accumulated depreciation	4350	9150	
Office Equipment	11700		
Less: accumulated depreciation	6840	4860	
Total non-current Assets			14010
Total Assets:			171555
Liabilities:			
Current:			
Sales salaries payable:		2100	
Accounts payable:		28600	
Total current Liabilities			30700
Owner's Equity			
Capital		96000	
Net Income	49355		
Less: Drawings	4500	44855	
Capital on 31.12.1991			140855
Total Liabilities and Owner's Equity:			171555

ILLUSTRATION NO. 3

The following Trial Balance was extracted from the books of AB & Co. on 31.12.1989:

	Rs.		Rs.
Purchases	10944	Capital	11,380
Sales Return	120	Mortgage Loan	4,000
Opening Inventory	4396	Accounts Payable	1300
Discount on Sales	260	Sales	25,360
Office Equipment	14,000	Purchases Returns	130
Accounts Receivables	4,500	Interest	1,520
Cash in hand	415	Allowances for uncollectible	300
Salaries	1305		
Rent	1200		
Furniture	2,000		
Advertisement	2150		
Insurance	900		
Wages	950		
Uncollectibles	250		
Commission	600		
	43,990		43,990

Adjustments:

1. Rent paid in advance Rs. 350
2. Accrued Interest Rs. 120
3. Outstanding Salaries Rs. 295
4. Depreciate Equipment at 10 % & Furniture at 20 %.
5. Closing Inventory was valued at Rs. 7500.
6. Allowance for Uncollectible is maintained at 5 % on accounts receivable.

Required: Draw up an Income Statement and a Balance Sheet as on 31.12.1989.

Ans:

AB & CO.
Income Statement
For the year ended 31st December 1989

References	Amount Rs.	Amount Rs.	Amount Rs.
Sales Revenue		25360	
Less: Sales Returns	120		
" Discount on Sales	260	380	
Net Sales			24,980

Less: **Cost of Goods Sold:**				
Opening Inventory			4396	
Add: Purchases		10,944		
Less: Purchases Returns		130		
Net Purchases		10,814		
Add: Wages		950		
Delivered cost of Net Purchases			11,764	
Cost of goods available for sale			16,160	
Less: Closing Inventory			7500	8660
Gross Income				16,320
Less: **Operating Expenses:**				
Selling & Distribution Expenses:				
Insurance		900		
Advertisement		2150		
Allowances for Uncollectible:				
Allowance for uncollectible required	Rs. 225			
Add: Uncollectibles	Rs. 250			
	Rs. 475			
Less: Existing Allowance for uncollectible	Rs. 300	175		
Commission		600	3825	
Office & Administration Expenses:				
Salaries	Rs. 1305			
Add: Outstanding Salaries	Rs. 295	1600		
Rent	Rs. 1200			
Less: Prepaid Rent	Rs. 350	950		
Depreciations				
On Furniture	Rs. 400			
On Office Equipment	Rs. 1400	1800	4250	8075
Operating Income				8245
Add: **Other Revenues:**				
Interest			1520	
Add: Accrued Interest			120	1640
Net Income				9885

AB & Co.
Balance Sheet
As on 31st December 1989

	Rs.	Rs.	Rs.
ASSETS:			
Current Assets:			
Cash in hand		415	
Prepaid Rent		350	
Accrued Interest		120	
Closing Inventory		7500	
Accounts Receivables	4500		
Less: Allowance for Uncollectibles	225	4275	
Total current assets			12660
Fixed Assets:			
Office Equipment	14000		
Less: Depreciation	400	12600	
Furniture	2000		
Less: Depreciation	400	1600	
Total fixed Assets			14200
Total Assets			26860
LIABILITIES:			
Current Liabilities:			
Accounts Payable		1300	
Outstanding Salaries		295	
Total Current Liabilities			1595
Fixed & Long Terms Liabilities:			
Mortgage Payable		4000	
Capital	11380		
Add: Net Income	9885	21,265	
Total Fixed & long term Liabilities			25265
Total Liabilities			26860

ILLUSTRATION NO. 4

The following trial balance is extracted from the books of Hafiz & Co. on 31.12.1990:

	Rs.		Rs.
Land & Building	10,000	Accounts Payable	2800
Office Equipment	6,000	Loan from ICP	7000
Inventory	3,000	Bills Payable	1000
Drawings	650	Return Outward	1100
Carriage In	250	Sales	25000
Cash in hand	335	Commission received	400
Loan to Ahmad	4,500	Capital	12000
Bills Receivable	2450		
Salaries	1,740		
Accounts Receivable	3,200		
Rent & Taxes	640		
Wages	360		
Postage	200		
Delivery Charges	300		
Sales Salaries	1200		
Interest on Loan	275		
Purchases	14,200		
	49,300		49,300

ADJUSTMENTS:

1. Closing Inventory was valued at cost Rs. 5500 market value Rs. 6200.
2. Outstanding wages Rs. 200 and salaries Rs. 400.
3. Rent prepaid Rs. 150.
4. Depreciation on fixed assets at 5 % p.a.
5. Commission unearned Rs. 150.
6. Create an allowance on Accounts Receivable at 5 % for Uncollectibles.

Required: Prepare an Income Statement and Balance Sheet as on 31.12.1990

Ans:

HAFIZ & CO.
Income Statement
For the year ended 31st December 1990

	References		Amount Rs.	Amount Rs.	Amount Rs.
	Sales Revenue				25000
Less:	**Cost of Goods Sold:**				
	Opening Inventory			3000	
Add:	Purchases		14200		
Less:	Return outward				
			1100		
Net	Purchases		13,100		
Add:	Carriage In		250		
Wages		Rs. 360			
Add:	Wages Outstanding	Rs. 200	560		
Delivered cost of Net purchases				13,910	
Cost of goods available for sale				16,910	
Less: Closing Inventory					11,410
				5,500	
Gross Income					13,590
Less:	**Operating Expenses:**				
Office & Administration Expenses:					
Salaries		Rs. 1740			
Add: Salaries Outstanding		400	2140		
Rent & Taxes		Rs. 640			
Less: Prepaid Rent		150	490		
Postage			200		
Depreciations:					
On Land & Building		Rs. 500			
On Office Equipment		300	800	3,630	
Selling & Distribution Expenses:					
Delivery Charges			300		
Sales Salaries			1200		
Allowances for uncollectibles			160	1660	5290
	Operating Income				8300
Add:	**Other Revenues:**				
Commission received				400	
Less:	Unearned Commission			150	250
Less:	**Financial & other Expenses:**				8550
	Interest on Loan				275
Net Income					8275

HAFIZ & CO.
Balance Sheet
As on 31st December 1990

	Rs.	Rs.	Rs.
ASSETS:			
Current Assets:			
Cash in hand		335	
Bills Receivable		2450	
Accounts Receivable	3200		
Less: Allowances for uncollectible	160	3040	
Loan to Ahmad		4500	
Closing Inventory		5500	
Prepaid Rent		150	
Total Current Assets			15975
Fixed Assets:			
Land & Building	10,000		
Less: Depreciation	500	9500	
Office Equipment	6000		
Less: Depreciation	300	5700	
Total Fixed Assets			15200
Total Assets			31,175
LIABILITIES:			
Current Liabilities:			
Accounts Payable		2800	
Bills Payable		1000	
Unearned Commission		150	
Outstanding Wages		200	
Outstanding Salaries		400	
Total Current Liabilities			4550
Fixed & Long Term Liabilities:			
Loan from ICP		7,000	
Capital	12,000		
Less: Drawings	650		
	11,350		
Add: Net Income	8275	19625	
Total Fixed & long term Liabilities			26625
Total Liabilities			31,175

QUESTIONS

1. What do you mean by Financial Statements? Why are these statements prepared?
2. What do you mean by cost of goods sold? How is it determined?
3. Explain and give the format of Income Statement, Balance Sheet and Cost of Goods Sold.

PROBLEMS

1. Ascertain the cost of goods sold from the following particulars:

		Rs.
(i)	Opening Merchandise Inventory	19500
(ii)	Purchases (gross)	150,000
(iii)	Purchases Discounts	3500
(iv)	Purchases returns and allowances	2900
(v)	Freight Inwards	7000
(vi)	Customs duty and clearing charges	2700
(vii)	Closing Merchandise inventory	30900

Ans: *[Cost of goods sold = Rs. 141900]*

2. Ascertain the gross income from the following particulars:

	Rs.
Purchases during the year, 1990	350,000
Purchases discounts	3700
Purchases returns and allowances:	2050
Sales: 470,000	
Sales discount	1500
Sales returns and allowances:	2200
Merchandise inventory on 1.1.1990	50500
Merchandise inventory on 31.12.1990	30,800
Transportation Inwards:	9500

Ans: *[Gross Income Rs. 92850]*

3. The following balances are extracted from the books of Asif & Bros. for the year ended 31st December, 1991. You are required to prepare an income statement for the year ended 31.12.1990.

	Rs.
Merchandise inventory on 1.1.90	36000
Purchases	140,000
Purchases discounts	3000
Purchases returns and allowances	2500
Sales	175000

Sales discounts	1200
Sales returns and allowances	1600
Carriage inwards	800
Wages:	1500
Sales Salaries	15000
Advertising expenses:	9600
Utilities expenses:	7000
Insurance:	950
Rent, rates and taxes	2300
Commission to salesmen:	1900

The Merchandise inventory on 31.12.1990 was valued at Rs. 53000:

Ans: *[Gross profit Rs. 52400; Net income Rs. 15650]*

4. The following Trial Balance was extracted from the books of Naeem & Sons on 31st March, 2000. From this you are required to prepare an income statement for the year ended on 31.3.2000 and a Balance Sheet as at that date:

Trial Balance On 31.3. 2000

	Dr. Rs.	Cr. Rs.
Cash	5000	
Account Receivable	9000	
Merchandise inventory on 1.4.1989	6000	
Plant and Machinery	24000	
Land and Building	82000	
Furniture and Fixtures	2600	
Capital:		136000
Accounts payable		3800
Purchases:	60,000	
Purchases returns and allowances		2200
Discount on purchases:		600
Sales:		70,000
Sales returns and allowances	3000	
Sales Discount	1600	
Insurance prepaid:	3400	
Advertisement expenses	4000	
Salaries expenses:	12000	
	212600	212600

ADDITIONAL INFORMATION:

1. Prepaid insurance on 31.3.2000 is Rs. 1400
2. Outstanding salaries Rs. 1000.
3. Depreciation on plant and machinery @ 10% p.a.
4. Merchandise inventory on 31.3.2000 was valued at Rs. 6000.

Ans: *[G.P. Rs. 8200, Net loss Rs. 13200; B/S 127600]*

5. The following are the balances extracted from the books of Usman Traders as at 31st December, 2000;

	Rs.		Rs.
Inventory (1.1.2000)	45,270	Capital	555,400
Drawings	4,550	Accounts payable	45,750
Buildings	400,000	Allowances for uncollectible	4,125
Office Equipment	100,000	Rent received	21,125
Cash in hand	29,150	Discount	2,850
Cash at bank	116,540	Sales	392,470
Accounts Receivable	69,750	Purchases Return	12,280
Prepaid Advertisement	10,150	9% bank loan	42,000
Purchases	232,710		
Sales Returns	5,540		
Carriage in	7,825		
Salaries	37,875		
Travellers commission	3,940		
Office Expenses	4,500		
Discount	2,150		
Insurance	4,270		
Interest on loan	1,780		
	1076,000		1076,000

ADJUSTMENTS:

1. Merchandise Inventory at 31.12.2000 was valued at Rs.25470.
2. Prepaid advertisement Rs.3520; insurance unexpired Rs.2140.
3. Interest on bank loan is outstanding.
4. Allow interest on capital at 5% p.a. & 3% on drawings.
5. Depreciate building at 5% and equipment at 10%.

Req: Prepare Income Statement and Balance Sheet.

Ans: *[G.I. Rs.138875, N.I. Rs.48336.5, B/s Rs.716570]*

6. The following Trial Balance has been extracted from the books of Nazir & Co. on 31.12.2000. From this prepare an Income Statement and Balance Sheet:

	Rs.		Rs.
Cash at Bank	30,000	Accounts payable	55,000
Accounts Receivable	45,090	Owner Equity	130,000
Bills Receivable	15,450	Drawings	5,500
Merchandise Inventory	31,400	Purchases	146,200
Unexpired Insurance	4800	Sales	225,000
Repair Charges	3600	Sales Returns	3400
Telephone Charges	6000	Purchases Returns	2890
Fixtures	20,000	Customs duty	5700

Business Premises	65,000	Sales Salaries	10,800
Depreciation fund	7,500	Advertisement	5400
Office Salaries	12,350	Office Expenses	1350
Interest Income	790	Delivery Charges	2150
Wages	7080		

ADJUSTMENTS:

1. Closing inventory is valued at Rs. 54000.
2. Depreciate fixed assets by 10 %.
3. Write off Rs. 3000 as uncollectibles and make allowance for uncollectible at 5 % on accounts receivable and allowance for discount on accounts receivable at 2 %.
4. Interest earned but still receivable Rs. 410.
5. A bill receivable Rs. 4500 not yet due was discounted on 20th December, 2000.

Ans: *[Gross Income Rs. 88110, Net Income Rs. 33262, B/S Rs. 228,762]*

7. On 31st December 2000, the following Trial Balance was extracted from the books of Kashif Traders:

Furniture	65,000	Rent	32,500
Sales Ledger Balance	74,750	Salaries	18,100
Merchandise Inventory on 31.12.2000	42,500	Bought ledger balance	61,750
		Income Tax	950
Purchases Adjusted	181,400	Bank overdraft	18,350
Cash in hand	8,220	Sales	296,450
Freight	4,370	Capital	98,000
Taxes and Insurance	8,000	Allowance for uncollectible	2,950
Carriage on sales	2,910	Sales salaries	24,160
Utilities charges	10490	Accountancy fee	4,150

ADJUSTMENTS:

1. Taxes outstanding Rs.2000; Insurance unexpired Rs.500.
2. Write off Rs.750 as uncollectibles and make an allowance for uncollectible at 5 % on receivables.
3. Reserve for discount on debtors and creditors at 2 %.
4. Goods costing Rs.5000 were taken by Kashif for his personal use, for which no record has been kept.

Req: Prepare Income Statement and Balance Sheet.

Ans: *[G.I. Rs.115680, N.I. Rs. 12,199, B.S. Rs.185,114]*

8. From the following Trial Balance prepare Trading and Profit & Loss A/c / Income statement for the year ending 30th June 2001 and a Balance Sheet as at that date.

	Dr.	Cr.
Capital		105,600
Plant & Machinery	143,375	
Purchase (less returns)	122,625	
Sales (less returns)		294,400

Opening Inventory	59,500	
Debtors and Creditors	62,375	45,750
Salaries & Wages	16,540	
Trade Expenses	750	
Rent & Insurance	12,250	
Bad Debts	1,460	
Allowance for Uncollectible		1,250
10% Govt. securities (1.1.2001)	49,550	
Rent payable		750
Depreciation on Plant & Machinery	11,625	
Cash at bank	19,950	
Commission		8,250
12% Bank loan (1.10.2000)		44,000
	500,000	500,000

ADJUSTMENT:

1. Closing Stock valued at cost Rs.42,500 (Market value Rs.45,000).
2. Goods costing Rs.10,000 destroyed by fire. Insurance Co. admitted the claim for a loss of Rs.6,250.
3. Commission received in advance Rs.4750.
4. Raise bad debts provision to 4% of debtors.
5. A bill receivable Rs.5000 not yet due was discounted on 15th June,2001.

Ans: *[G.I. 164775, N.I. 119173, B/s 323983]*

9. From the following particulars prepare financial statements for the year ending 1st December 2001.

	Dr.	Cr.
Cash in hand	9,730	
Cash at bank	39,748	
Stock on 1.1.2000	59,552	
Wages	4,750	
Royalty	1,040	
Octori duty	3,660	
Purchases & Sales	215,170	352,750
Returns Inward	5,430	
Returns Outward		2,250
Rent	7,950	
Salaries	25,450	
Goodwill	20,000	
Plant & Machinery	24000	
Debtors & Creditors	115,500	51,640
Bad Debts	3,760	
Provision for bad debts		4,355
Loan to Mr. X	16,260	
Rent by sub–letting		5,155

Liabilities for expenses		1,250
Loan from Mr. Y		14,800
Capital		120,550
Bank Charges	750	
	552,750	552,750

ADJUSTMENT:

1. Closing stock was valued at Rs.51,250.
2. Increase bad debts provision by 5% on sundry debtors.
3. Closing stock included Rs.11,450 worth of goods received for which the invoice was not received.
4. Manager is entitled to a commission of 10% on net profit after charging such commission.

Ans: *[G.I. 105198, N.I. 64025, B/s 271118]*

10. The following are the balances extracted from the books of Waseem Traders as at 31st December, 1998:

	Rs.		Rs.
Capital	110,000	Traveller's Commission	8,450
Drawings	6,500	Rent Recovered	2400
Buildings	80,000	Cash in hand	1450
Furniture	30,000	Cash at bank	5000
Equipments	10,000	Accounts Receivable	40,500
Purchases	169,600	Accounts Payable	35,200
Purchases Returns	2400	Advertisement	3,200
Sales	273,500	Discount (Dr.)	750
Sales Returns	3500	Office Expenses	2100
Inventory (1.1.98)	32,210	Addition to Building	5000
Salaries	28,000	General Charges	3400
Freight out	2,000	Bank Overdraft	9,450
Printing & Stationery	3500	Excise Duty	1250
Uncollectibles	650	Insurance	1640
Allowances for Uncollectible	3,500	Packing Exp.	1110
Discount (Cr.)	3360		

ADJUSTMENTS:

1. Goods taken by Waseem for his household use were Rs. 3500.
2. Advertisement was paid up to 31st March 1999.
3. Depreciation on building 2 % on furniture 5 % and on equipment 10 % p.a.
4. Charge interest on capital at 10 %.
5. Closing inventory was valued at Rs. 40,000.
6. Allowances for uncollectible to be made upto Rs. 3500.

Prepare Income Statement and Balance Sheet as on 31st December 1998.

Required: Prepare financial statements.

Ans: *[Gross Income Rs. 112,840 Net Income Rs. 49500 B/S Rs. 205150]*

11. From the following information, prepare Income Statement and Balance Sheet as at 31.12.1997 after taking into account the following adjustments.

(a) Closing Inventory has ben valued at Rs. 2400.

(b) Goods worth Rs. 1500 have been taken by the proprietor for his private use.

(c) One quarter of insurance premium falls in the next year.

(d) Depreciation is charged on furniture at 10 % p.a.

(e) Allowance for uncollectible is maintained at 5 %.

	Rs.		Rs.
Cash in hand	3480	Rent by Sub-letting	200
Discount	240	Sales	29480
Furniture	1200	Discount	120
Goodwill	2000	Allowances for uncollectible	400
Uncollectible	200	Liabilities for Expenses	760
Wages	40	Rent payable	40
Insurance	240	6 % Loan from Y (1.1.1997)	2000
Advertisements	1200	Return Outward	200
Accounts Receivable	12000	Capital	16000
Purchases	24000	Accounts Payable	5200
Inventory on 1.1.97	2400		
Carriage Inward	400		
Carriage Outward	200		
Returns Inwards	320		
8 % Loan to X on 1.7.1997	1200		
Salaries	2400		
Rent	480		
Drawings	2400		
	54400		54400

Ans: *[Gross Income Rs. 6420 Net Income Rs. 1448 B/S Rs. 21668]*

12. The Balance Sheet items for Mughal Autos were as follows at June 30, 1994:

	Rs.		Rs.
Accounts Payable	4000	Land	40,000
Accounts Receivable	300	Notes Payable	46,000
Building	20,000	Supplies	2,800
Cash	4600	Saleem Mughal's Capital	?
Equipment	26,000		

During the next three days, the following transactions occurred:

July 1: Saleem invested an additional Rs. 15000 cash in the business. Half of the accounts payable were paid. A note payable amounting to Rs. 6,000 was also paid.

July 2: Equipment was purchased at a cost of Rs. 9,000 to be paid within ten days. Supplies were purchased for Rs. 500 in cash.

July 3: Some repair work was completed for which an amount of Rs. 700 is to be received within next week.

Required: (a) Balance Sheet as on June 30, 1994.
(b) Balance Sheet as on July 03, 1994.

Ans: *[(i) B/S Rs. 93700 (ii) B/S Rs. 110400]*

13. From the following information prepare an income statement for the year ended 31st December 1998 and a Balance Sheet as on that date:

	Rs.		Rs.
Capital	120,000	Repairs & Renewals	1800
Accounts Payable	15,200	Buildings	54,000
Bills Payable	1,000	Office Equipment	35,000
Commission Payable	2,300	Furniture	10,000
Sales	618,000	Carriage Outward	1,250
Discount Received	1,100	Packing Expenses	2,150
Inventory	95,000	Advertisement	11,400
Purchases	468,000	Prepaid Insurance	5,400
Carriage Inward	8,900	Travelling Expenses	2,300
Sales Salaries	750	Cash in hand	2,250
Accounts Receivable	50,000	Allowances for uncollectible	2,000
Uncollectibles	1,400		
Salaries	10,000		

Inventory as on 31st December 1998 was valued at Rs. 109,000. Office Equipment is to be depreciated at Rs. 3100 Buildings at 7.5 % and Furniture at 15 %. Allowances for uncollectible is to be created at 5 % on accounts receivable. Allowance for discount on Accounts Receivable at 2 %. Insurance prepaid Rs. 2400, salaries payable Rs. 500.

Ans: *[Gross Income Rs. 155100 Net Income Rs. 111550 B/S Rs. 250550]*

14. The following Trial Balance has been extracted from the books of A & B who are sharing profit & loss in the ratio of 3:2 on 31st December, 1998:

	Rs.		Rs.
Merchandise Inventory	40,000	Capital A	100,000
Discount on Sales	750	B	70,000
Accounts Receivable	72,000	Accounts Payable	46,000
Wages	14,500	Bank Overdraft	24,000
Furniture	28,000	Sales	222,000
Office Equipment	35,000	Discount on Purchases	1400
Cash in hand	6,250	Allowances for uncollectible	4,000
Purchases	174,500		

Uncollectibles	2,600	
Drawings A	12,000	
Drawings B	9,000	
Coal, Gas & Water	8,600	
Rent & Rates	10,600	
Postage	2,400	
Office Supplies	15,800	
Commission	8,900	
Sales Salaries	26,500	
	467400	467400

ADJUSTMENTS:

1. Closing Inventory was valued at cost Rs. 95000.
2. Office Supplies were valued at Rs. 7,500 on 31.12.1998.
3. Raise allowance for uncollectible by 5 % on Accounts Receivable.
4. Wages outstanding Rs. 1500.
5. Rent and rates prepaid Rs. 4000.
6. Interest Rs. 3000 accrued on overdraft.

Required: Prepare an Income Statement for the year ended 31st December 1998 and Balance Sheet as on that date.

Ans: *[Gross Income Rs. 78550 Net Income Rs. 19250 B/S Rs. 242750]*

15. Some of the items of Assets, Expenses, Liabilities and Revenues appearing in the Trial Balance are given as under:

	Rs.		Rs.
Prepaid Insurance	1200	Unearned Management Fees	24000
Office Supplies	1000	Capital	60,000
Building	24000		
Accounts Receivable	12600		
Salaries Expenses	9700		

From the following additional information you are required to record the adjusting Journal entires and show how these adjustments will affect the financial statements.

(a) Insurance expenses of the period were Rs. 1000.

(b) Office Supplies in hand at the close of the period were valued at Rs. 300.

(c) Three-Fourth of the Management work was completed till the close of the period.

(d) Salaries of the office worker amounting to Rs. 300 were yet to be paid.

(e) Write off Rs. 600 as bad debts and raise an allowance for uncollectibles equal to 5 % of the Accounts Receivable.

(f) Allow 5 % interest on capital.

16. Following is the Trial Balance of a firm. From this you are required to prepare an income statement for the year ending on 31st December, 2000 and a Balance Sheet as on that date.

Trial Balance On 31.12. 2000

	Dr. Rs.	Cr. Rs.
Cash at Bank	80,000	
Accounts receivable	35200	
Stores supplies	5000	
Prepaid Rent	11240	
Furniture and Fixtures	7600	
Accumulated depreciation- Furniture and Fixture		1520
Prepaid Insurance:	8500	
Plant a Machinery	45000	
Accumulated depreciation - plant and Machinery		9000
Capital:		165000
Accounts payable:		8500
Drawings	31000	
Sales revenue:		212980
Salaries expense	9500	
Advertising expense	7000	
Purchases:	95000	
Wages:	10,000	
Purchases returns		6500
Sales returns	3000	
Merchandise Inventory on 1.1.2000	45000	
Travelling expenses:	5460	
Miscellaneous expenses:	5000	
	403500	403500

ADJUSTMENTS:

1. Merchandise inventory on 31.12.2000 was valued at Rs. 35000.
2. Store supplies on hand 31. 12.2000 Rs. 1500.
3. Prepaid rent expired Rs. 9240.
4. Prepaid insurance expired Rs. 6000.
5. Depreciate furniture and fixture and plant and Machinery by 10% p.a.
6. Accrued salaries Rs. 3000.
7. Write off bad debts from accounts receivable Rs. 1500.

Ans: *[Gross income Rs. 101480; Net income Rs. 46020; B/S 191520]*

17. On 31st December 1991, the following Trial Balance was extracted from the books of a Merchant:

	Rs.		Rs.
Business Premises	80,000	Accounts Payable	8,852
Furniture	25,000	Bank Overdraft	4900
Sales Ledger Balance	35,000	Sales	131,000
Opening Inventory	20,000	Capital	95,000
Cash in hand	1,400	Allowance for uncollectible	1,450
Marketable Securities	15,000	Interest on Securities	448
Prepaid Advertisement	6,000	10 % Bank Loan	58,350
Purchases	92,500		
Freight	3,650		
Salaries	12,400		
Taxes & Insurance	1,250		
Uncollectibles	750		
Accountancy Fee	800		
General Charges	1,800		
Travelling Expenses	500		
Discount Allowed	330		
Sales Return	245		
Carriage on Sales	375		
Bills Receivable	3,000		
	300,000		300,000

ADJUSTMENTS:

1. Closing inventory was valued at Rs. 32500.
2. Advertisement expired during the year Rs. 4500.
3. Taxes outstanding Rs. 250 and Insurance paid in advance Rs. 200.
4. Interest accrued on securities Rs. 452.
5. Depreciate premises at 5 % and furniture at 10 %.
6. Interest on bank loan outstanding for six months.
7. Raise allowances for uncollectible by 5 % on Accounts Receivable.

Required: Prepare financial statements.

Ans: *[Gross Income Rs. 47105 Net Income Rs. 14832 B/S Rs. 185102]*

18. The following Trial Balance has been extracted from the Books of Sohail & Co. for the year ended on 31st December 1998.

	Rs.		Rs.
Cash at Bank	3950	Accounts Payable	32000
Accounts Receivable	65000	Capital	135000
Merchandise Inventory	40800	Sales	190000
Prepaid Rent	6650	Purchases Return	3,100
Office Supplies	7000	Allowance for uncollectibles	4,950
Furnitures & Fixture	18,000	Accumulated Depreciation	
Office Equipment	42000	On Furniture	3,600
Purchases	142000	Accumulated Depreciation	
Sales Returns	2,400	on Equipment	8,400
Royality paid	4,500	Loan from Asif	10,000
Salaries	20,300		
Postage & Telegram	3,440		
Carriage Out	2,660		
Salemen's Salaries	9,450		
Audit Fee	2,500		
Legal Charges	3,000		
Wages	4,500		
Insurance	6,500		
Uncollectibles	2400		
	387,050		387,050

ADJUSTMENTS:

1. Closing Inventory was valued at Rs. 89000.
2. Office Supplies on hand at 31.12.1998 Rs. 2500.
3. Depreciate furniture and Equipment at 10 %.
4. Rent prepaid Rs. 2450.
5. Wages payable Rs. 500; Salaries accrued Rs. 1000.
6. Raise allowances for uncollectible by $2\frac{1}{2}$ % on account receivable.
7. The manager is entitled to a commission of 10 % on the net profit after charging, such commission.

Required: Prepare an Income Statement and Balance Sheet.

Ans: *[Gross Income Rs. 87400 Net Income Rs. 20205 B/S Rs. 200725]*

CHAPTER - 14

CAPITAL AND REVENUE

CAPITAL AND REVENUE

As we know, in every business transaction either there is an inflow of money or an outflow of money. In order to know the true and fair result and financial condition of a business for a year, the nature of the transactions taking place during the year has to be analysed. Transactions may be divided into two classes according to their character--capital transactions and revenue transactions. Some transactions have long-term effect, while some others have short-term effect. Transactions having long-term effect are known as "capital transactions" and those having short-term effect are known as **"revenue transactions".** For example, a building is used for a long time, so purchase of building is capital transaction. In the same way stationery etc. are meant for day to day use and are consumed in a short time, so purchase of stationery etc., is a revenue transaction.

Thus we can say, the transactions, the effect of which is not exhausted within the current accounting year or the benefit of which is received by the business for a number of years, are called capital transactions. On the other hand the transactions, the effect of which is exhausted within the current accounting year or the benefit of which is received by the business within a year, are called revenue transactions.

Business Transactions

- Short-Term → Revenue Transactions
  - Revenue Receipts (inflows)
  - Revenue Expenditures (out flows)
- Long-Term → Capital Transactions
  - Capital Receipts (inflows)
  - Capital Expenditures (out flows)

CAPITAL AND REVENUE EXPENDITURE

Whenever we spend money we exchange it for some useful goods or services, but the benefit received from the expenditure varies in duration. If we buy furniture it may last for twenty years, and even then give quite satisfactory service at the end. If we buy a stamp and stick it on a letter, it will last a much shorter time.

The difference between these two types of expenditures is the difference between *capital expenditure and revenue expenditure.* It is of great importance in understanding Final Accounts because it is the key that decides whether an expenditure is considered as an expense loss or an asset.

The chief difference between the two types of expenditure is the length of time for which they benefit to the business and since we have to draw a line somewhere so it is sensible to draw this line at one year. If a good or a service. lasts less than one year it is "revenue expenditure. If it lasts longer than one year it is "capital expenditure".

CAPITAL EXPENDITURE

An expenditure which results in the acquisition of permanent asset which is intended to be permanently used in the business for the purpose of earning revenue, is known as capital expenditure. These expenditures are 'non-recurring' by nature. Assets acquired by incurring these expenditures are utilised by the business for a long time and thereby they earn revenue. For example, money spent on the purchase of building, machinery, furniture etc. Take the case of machinery--machinery is permanently used for producing goods and profit is earned by selling those goods. This is not an expenditure for one accounting period, machinery has long life and its benefit will be enjoyed over a long period of time. By long period of time we mean a period exceeding one accounting period.

Moreover, any expenditure which is incurred for the purpose of increasing profit earning capacity or reducing cost of production is a capital expenditure. Sometimes the expenditure even not resulting in the increase of profit earning capacity but acquires an asset comparatively permanent in nature will also be a capital expenditure.

It should be remembered that when an asset is purchased, all amounts spent up to the point till the asset is ready for use should be treated as capital expenditure. Examples are: (a): A machinery was purchased for Rs. 50,000 from Karachi. We paid carriage Rs. 1,000, octroi duty Rs. 500 to bring the machinery from Karachi to Lahore. Then we paid wages Rs. 1,000 for its installation in the factory. For all these expenditures, we should debit machinery account instead of debiting carriage A/c, octroi A/c and wages A/c. (b): Fees paid to a lawyer for drawing up the purchase deed of land. (c): Overhaul expenses of second-hand machinery etc. (d): Interest paid on loans raised to acquire a fixed asset etc.

OTHER EXAMPLES:

1. Purchase of furniture, motor vehicles, electric motors, office equipment, loose tools and other tangible assets.
2. Cost of acquiring intangible assets like goodwill, patents, copy rights, trade marks, patterns and designs etc.
3. Addition or extension of assets.
4. Money spent on installation and erection of plant and machinery and other fixed assets.
5. Wages paid for the construction of building.
6. Structural improvements or alterations in fixed assets resulting in an increase in their useful life or profit earning capacity.
7. Cost of issue of shares and debentures (certain expenditures are incurred by the companies when share and debentures are issued).
8. Legal expenses on raising loans for the purchase of fixed assets.
9. Interest on loan and capital during the construction period.
10. Expenditures incurred for the development of mines and plantations etc.
11. Money spent to bring a second-hand asset into working condition.
12. Cost of replacing factory building from an old place to a new and better site.
13. Premium given for a lease.

REVENUE EXPENDITURES:-

All the expenditures which are incurred in the day to day conduct and administration of a business and the effect of which is completely exhausted within the current accounting year are known as "*revenue expenditures.*" These expenditures are recurring by nature i.e. which are incurred for meeting day to day requirements of a business and the effect of these expenditures is always short-lived i.e. the benefit thereof

is enjoyed by the business within the current accounting year. These expenditures are also known as "*expenses or expired costs.*" e.g. Purchase of goods, salaries paid, postages, rent, travelling expenses, stationery purchased, wages paid on goods purchased etc.

This expenditure is incurred on items or servies which are useful to the business but are used up in less than one year and, therefore, only temporarily increase the profit-making capacity of the business.

Revenue expenditure also includes the expenditure incurred for the purchase of raw material and stores required for manufacturing saleable goods and the expenditure incurred to maintain the fixed assets in proper working conditions i.e. repair of machinery, building, furniture etc.

Following are the examples of revenue expenditure.

1. Wages paid to factory workers.
2. Oil to lubricate machines.
3. Power required to run machine or motor.
4. Expenditure incurred in the ordinary conduct and administration of business. i.e. rent, carriage on saleable goods, salaries, wages manufacturing expenses, commission, legal expenses, insurance, advertisement, free samples, postage, printing charges etc.
5. Repair and maintenance expenses incurred on fixed assets.
6. Cost of saleable goods.
7. Depreciation of fixed assets used in the business.
8. Interest on borrowed money.
9. Freight, cartage, octroi duty, transportation, insurance paid on saleable goods.
10. Petrol consumed in motor vehicles.
11. Service charges to motor vehicles.
12. Bad debts.

Distinction between Capital Expenditure and Revenue Expenditure

Revenue Expenditure	Capital Expenditure
1. Its effect is temporary, i.e. the benefit is received within the accounting year.	1. Its effect is long-term, i.e. it is not exhausted within the current accounting year--its benefit is received for a number of years in future.
2. Neither an asset is acquired nor the value of an asset is increased.	2. An asset is acquired or the value of an existing asset is increased.
3. It has no physical existence because it is incurred on items which are used by the business.	3. Generally it' has physical existence except intangible assets.
4. It is recurring and regular and it occurs repeatedly.	4. It does not occur again and again. It is non-recurring and irregular.
5. This expenditure helps to maintain the business.	5. This expenditure improves the position of the business.
6. The whole amount of this expenditure is shown in trading P & L A/c or income statement.	6. A portion of this expenditure (depreciation on assets) is shown in trading & P & L A/c and the balance is shown in the balance sheet on asset side.
7. It does not appear in the balance sheet.	7. It appears in the balance sheet until its benefit is fully exhausted.
8. It reduces revenue (profit) of the business.	8. It does not reduce the revenue of the concern. Purchase of fixed asset does not affect revenue.

ILLUSTRATION NO. 1

State with reasons whether the following items of expenditure are capital or revenue.

(i) Wages paid on the purchase of goods.
(ii) Carriage paid on goods purchased.
(iii) Transportation paid on machinery purchased.
(iv) Octroi duty paid on machinery.
(v) Octroi duty paid on goods.
(vi) A second-hand car was purchased for Rs. 7,000 and Rs. 5,000 were spent for its repairs and overhauling.
(vii) Office building was whitewashed at a cost of Rs. 3,000.
(viii) A new machinery was purchased for Rs.80,000 and a sum of Rs.1,000 was spent on its installation and erection.
(ix) Books were purchased for Rs. 50,000 and Rs. 1,000 were paid for carrying books to the library.
(x) Land was purchased for Rs. 1,00,000 and Rs. 5,000 were paid for legal expenses.
(xi) Rs. 50,000 were paid for customs duty and freight on machinery purchased from Japan.
(xii) Old furniture was repaired at a cost of Rs. 500.
(xiii) An additional room was constructed at a cost of Rs. 15,000.
(xiv) Damages paid on account of the breach of contract to supply certain goods.
(xv) Cost of replacement of an old and worn out part of machinery.
(xvi) Repairs to a motor car met with an accident.
(xvii) Rs. 10,000 paid for improving a machinery.
(xviii) Cost of removing plant and machinery to a new site.
(xix) Cost of acquiring the goodwill of an old firm.
(xx) Cost of redecorating a cinema hall.
(xxi) Cost of putting up a gallery in a cinema hall.
(xxii) Compensation paid to a director for loss of his office.
(xxiii) Premium paid on the redemption of debentures.
(xxiv) Costs of attending a mortgage.
(xxv) Commission paid on issue of debentures.
(xxvi) Cost of air-conditioning the office of the director of a company.
(xxvii) Repairs and renewal of machinery.
(xxviii) Cost of acquiring patent rights and trade marks.
(xxix) Compensation paid to workers for termination of their services.
(xxx) Compensation paid to a person injured by company's car.
(xxxi) Expenditures incurred on alteration in windows ordered by municipal authorities.
(xxxii) Painting expenditures of a newly-constructed factory.
(xxxiii) Expenditures incurred on renewal of patent.
(xxxiv) Expenditures on replacement of a slate roof by a glass roof.
(xxxv) Rs. 10,000 spent on dismantling, removing and reinstalling machinery and fixtures.
(xxxvi) Legal expenses incurred in an income tax appeal.

Solution:

	Sr. No.	Nature of Expenditure	Reasons
wages A/c is debited.	(i)	Revenue expenditure	Wages paid on goods purchased and a revenue expenditure because goods purchased are meant for resale. It is recurring by nature as goods are purchased repeatedly in a business.
Carriage A/c is debited.	(ii)	Revenue expenditure.	The carriage paid on purchases is a revenue expenditure because goods purchased are meant for resale and whenever goods are purchased carriage is paid to bring the goods to the godown of the business.
Machinery A/c is debited instead of transportation A/c.	(iii)	Capital expenditure.	A machinery purchased is useless until it is brought to the business. As machinery is a fixed asset and transportation paid is an additional cost to the machinery, so it is a capital expenditure.
Machinery A/c is debited instead of octroi duty A/c	(iv)	Capital expenditure.	Octroi duty paid on machinery is also an additional cost to the machinery. If it is not paid, the machinery cannot be taken to the business, so it is a capital expenditure.
Octroi duty A/c is debited.	(v)	Revenue expenditure.	Octroi duty paid on goods is a revenue expenditure because goods mean saleable goods. It is recurring and is paid repeatedly whenever goods are purchased.
For both expenditures motor-car A/c is debited.	(vi)	Capital expenditure.	A second-hand car is a fixed asset as it can be used for many years and its utility does not diminish in one year, so it is a capital expenditure. But it is useless if it is not made good to work, so the amount spent on its repair and overhauling is also a capital expenditure.
Whitewashing A/c is debited.	(vii)	Revenue expenditure.	Whitewashing of a building is necessary for its maintenance and because of this expenditure the profit earning capacity of the business has not increased, so it is a revenue expenditure.
Machinery A/c debited for all expenditure.	(viii)	Capital expenditure.	Machinery is a permanent asset of the business and can be used for many years but it will benefit to the business until it is installed and erected at a proper place. So amount spent on purchase of machinery, on its installation and erection is capital expenditure.
For both expenditures Books A/c is debited.	(ix)	Capital expenditure.	Fixed asset "Books" has been acquired and can be used for many years. Cost of carrying books is regarded as a part of purchase price of the books, so it is a capital expenditure.

Land A/c is debited.	(x)	Capital expenditure.	Land purchased is a fixed asset. All expenses connected with its acquisition are regarded as a part of its purchase price.
Machinery A/c is debited.	(xi)	Capital expenditure.	Machinery is a fixed asset. All expenses connected with its import from Japan are regarded as a part of its purchase price. So it is a capital expenditure.
Repair A/c is debited.	(xii)	Revenue expenditure.	Value of furniture does not increase as a result of its repair -- it is simply kept in a proper working condition.
Building A/c is debited.	(xiii)	Capital expenditure.	This is an addition to a fixed asset and as a result of this expenditure the value of the building has increased, so it is a capital expenditure.
Damages A/c or general expenses is debited.	(xiv)	Revenue expenditure.	In this case the goods have not been supplied by the business to the customer according to the contract between them. The customer claimed damages which the business paid. It is a usual thing that happens in ordinary course of trading, so it is a revenue expenditure.
Repair and maintenance A/c is debited.	(xv)	Revenue Expenditure	A worn out part of the machinery is replaced and is simply the cost of repair and maintenance of a fixed asset. The value and profit earning capacity of the machinery has not increased in any way, so it is a revenue expenditure.
Repair to car A/c is debited.	(xvi)	Revenue Expenditure	Cost of repair to a motor car does not increase the value of the car, it is simply incurred to put back the car into working condition, so it is a Revenue expenditure.
Machinery A/c is debited.	(xvii)	Capital expenditure.	Cost has been incurred to improve the machinery. It increases the value and profit-earning capacity of the machinery, so it is a capital expenditure.
Plant and Machinery A/c is debited.	(xviii)	Capital expenditure.	Plant and machinery have been removed to a new site in order to increase their profit-earning capacity, so cost of removal is a capital expenditure.
Goodwill A/c is debited.	(xix)	Capital expenditure.	Goodwill is an intangible asset and it will benefit to the business for many years. So cost of acquiring goodwill (using the name of an old firm) is always a capital expenditure.
Re-decoration A/c or Maintenance A/c is debited.	(xx)	Revenue expenditure.	Generally a cinema hall is decorated regularly and re-decorating cost is a recurring expenditure. Moreover, it will not add to the capacity of the hall, so it is a revenue expenditure.

Cinema hall A/c or Building A/c is debited.	(xxi)	Capital expenditure.	As a gallery has been put up in the cinema hall, it increases the capacity of the hall, which in turns enhances the profit-earning capacity of the business, therefore, the cost is treated as a capital expenditure.
Expense A/c is debited.	(xxii)	Revenue expenditure.	Compensation paid to the director of a company for the loss of his office is a revenue expenditure because the company will get the benefit of this expenditure only for one year.
	(xxiii)	Capital expenditure.	By issuing debentures, money is borrowed from the public for a long period of time and is used in the purchase of fixed assets or on the expansion of the business, therefore, premium paid is a capital expenditure.
	(xxiv)	Capital expenditure.	Mortgage means a deed showing that the money has been borrowed (loan raised) by mortgaging assets as collateral security. The assets will remain mortgaged with the lender until the loan has been repaid. So the assets have been utilized for raising loan and the costs attending the mortgage is, therefore, a capital expenditure.
	(xxv)	Capital expenditure.	Debentures are considered as borrowed capital and are used for the acquisition of fixed assets such as machinery etc., therefore, commission paid on issue of debentures is a capital expenditure.
	(xxvi)	Capital expenditure.	By making the office of the director air-conditioned, the efficiency of the director will increase and it will last for many years, so cost of air-conditioning is a capital expenditure.
Repair A/c is debited.	(xxvii)	Revenue expenditure.	Annual repair and renewal of machinery is necessary to keep it in a proper working condition, therefore, this expenditure is considered as a revenue expenditure.
	(xxviii)	Capital expenditure.	Patents and trade marks are intangible assets, the benefit of which is received for many years, so cost of acquiring these assets is a capital expenditure.
	(xxix)	Capital expenditure.	By terminating inefficient workers, the business will run more economically and profit-earning capacity of the business will increase, so compensation paid to them is a capital expenditure.

(xxx)	Revenue Expenditure	It happened in the ordinary course of business, so compensation paid to the injured person is a revenue expenditure.
(xxxi)	Revenue expenditure.	This expenditure will add nothing to the value of the building and will have no effect on the profit earning capacity of the business, so it is a revenue expenditure.
(xxxii)	Capital expenditure.	Amount spent on painting a new factory is regarded as a part of the cost of factory building, therefore, it is a capital expenditure.
(xxxiii)	Revenue expenditure.	If patent is renewed annually, then it is a revenue expenditure as it has been incurred in the ordinary course of business.
(xxxiv)	Capital expenditure.	As a slate roof is replaced by a glass roof, it will increase the efficiency of the building and, therefore, it is a capital expenditure.
(xxxv)	Revenue expenditure or deferred revenue expenditure	Amount of Rs. 10,000 spent on dismantling, removing and re-installing machinery and fixtures will be treated as revenue expenditure. It may be treated as deferred revenue expenditure item and spread over a number of years.
(xxxvi)	Revenue expenditure.	This expenditure has been incurred in the ordinary course of the business being expense of carrying on the business, therefore, it is a revenue expenditure.

When Revenue Expenditures are not regarded as Revenue Expenditures?

There are some items of expenditure which are revenue by nature, yet they are not regarded as revenue expenditure. Such expenditures may be divided into two groups.

1. Deferred Revenue Expenditure:

This is a revenue expenditure, the benefit of which is not confined to one accounting year-- it extends to future accounting year or years also. However, this expenditure does not result in the acquisition of any fixed asset. For example, heavy advertisement expenditure is incurred on introduction of a new product in the market. This is a revenue expenditure in nature and the benefit is enjoyed by the business over a number of years, but no asset of permanent nature is acquired. A portion of this expenditure is treated as revenue expenditure chargeable in the current accounting year and the remaining portion is temporarily treated as capital expenditure and shown on the Asset side of the Balance Sheet. Below are a few examples of such expenditure:

(a) Expenditure incurred to the formation of a joint stock company i.e. Preliminary Expenses.

(b) Expenditure on research and experiment connected with the introduction of a new product.

(c) Heavy expenditure on advertisement for marketing a new product.

(d) Heavy expenditure on repairs to property.

(e) Expenditure on removal of business from one place to another place.

2. Capitalised Expenditure:-

Some expenditures although of revenue nature basically, are directly connected with fixed assets and spent directly on the acquisition of fixed assets. Such expenditures are added to the cost of assets and are called "Capitalised Expenditures". For example, we buy a second-hand plant for Rs. 50,000. This is undoubtedly a capital expenditure. A further sum of Rs. 5,000 is spent on its repair and overhauling in order to bring the plant into proper working order. Expenditure on account of repair and overhauling, although revenue by nature, will be treated as Capital Expenditure in this case and will be debited to plant account not to Repairs A/c. Thus, a revenue expenditure which increases the utility or productive capacity of an asset, is treated as capitalised expenditure. Below are a few examples of such expenditure:

(a) Expenditure on installing an asset. i.e. installation charges.

(b) Expenditure on repair to property, if the production capacity or utility of the property is increased. It may, however, be noted that sometimes a new asset may require some repair after its purchase but before it is installed and put into operation. Cost of such repair, although it may not increase the production capacity of the asset, will be treated as a capitalised expenditure.

(c) Expenditure incidental to purchase of fixed assets, e.g. freight, clearing charges, customs duty, carriage, octroi duty, import duty on assets purchased.

(d) Expenditure on removal of old property.

(e) Cost of repair to second-hand assets: Repair is a revenue expenditure. But the cost of repair after buying a second-hand asset to bring them into proper working condition is treated as Capitalised Expenditure.

(f) Wages: It is a revenue expenditure but if paid for installation of a machine or plant, then it is treated as a capitalised expenditure.

(g) Legal Charges: Legal charges i.e. lawyer's fee, court fee in connection with the purchase of asset of permanent nature are regarded as capital expenditure.

(h) Interest: Interest paid is generally a revenue expenditure. But in some industries like iron & steel, cement industry etc., a concern has to wait for a long period before it starts operation. Interest for such period on capital and loan is treated as capital expenditure.

NOTE:

From the above discussion, the distinction between 'deferred revenue expenditure' and 'capitalised expenditure' may be noted. The amount of deferred revenue expenditure is generally heavy and it is spread over a number of years. But capitalised expenditure is added in full to the cost of concerned asset, whatever may be the amount of expenditure. Hence there is no question of apportioning the expenditure over a number of years.

ILLUSTRATION NO. 2

State with reasons whether the following should be considered as deferred revenue expenditure or capitalised expenditure.

1. **Preliminary expenses paid in the formation of a company.**
2. **Heavy advertisement expenses paid to introduce a new product in the market.**
3. **Wages paid for the installation of a machinery.**
4. **Carriage paid on the purchase of a machinery.**
5. **Cost of overhauling and painting a second-hand truck newly-purchased.**
6. **Research and experimental expenses to introduce a new product.**

Solution:

No.	Nature of Expenditure	Reason
1.	Deferred revenue expenditure.	At the time of formation of a company certain expenses are incurred which are revenue by nature e.g. cost of preparing documents, registration fee, cost of stamp etc. Such expenditures are large in amount and it will be logical to spread such expenditures over a number of years.
2.	Deferred revenue expenditure.	It is ordinarily a revenue expenditure. But if heavy advertisement expenses are paid to introduce a new product, then the benefit will be received for a number of years, so it is treated as deferred revenue expenditure.
3.	Capitalised expenditure or capital expenditure.	This expenditure is regarded as a part of the cost of machinery, so it is regarded as a capitalised expenditure.
4.	Capitalised expenditure.	Carriage paid on machinery is also regarded as an additional cost of the machinery, therefore, treated as a capitalised expenditure.
5.	Capitalised expenditure.	Cost of overhauling and painting is incurred to bring the second-hand truck into proper working order, so it is regarded as capitalised expenditure.
6.	Deferred revenue expenditure.	The benefit of this expenditure will be enjoyed for many years, so it is regarded as a deferred revenue expenditure.

NOTE: Both deferred revenue expenditure and capitalised expenditure are shown on the asset side of the Balance Sheet.

Principles for making distinction between Capital Expenditure and Revenue Expenditure:

We have no hard and fast rule for distinguishing capital expenditure from revenue expenditure because, the same item of expenditure may be treated as capital, revenue or deferred revenue depending upon the circumstances e.g., to a machinery dealer purchase of machinery is a revenue expenditure, while machinery purchased for manufacturing goods is a capital expenditure. In the same way, wage is generally a revenue expenditure, but wage paid for the installation and erection of a machinery is a capital expenditure. However, generally the following principles are followed to make a distinction between capital expenditure and revenue expenditure.

1. Any expenditure that benefits the business for several accounting years, is regarded as a capital expenditure; any expenditure that benefits the business only for one accounting year is considered a revenue expenditure.
2. Any expenditure which is not incurred repeatedly and regularly (non-recurring) is a capital expenditure, while any expenditure which is incurred again and again (recurring) is a revenue expenditure e.g., motor car is not bought again and again, but petrol required to drive it is to be bought at regular intervals.
3. Any expenditure incurred to improve the concern or to increase the profit-earning capacity of the concern is a capital expenditure. On the other hand, expenditure incurred to keep the activities of a concern going, is revenue expenditure.
4. Expenditure incurred after buying second-hand asset to bring it into proper working order is a capital expenditure.

5. Expenditure incurred on the purchase and installation of a new asset is regarded as capital expenditure.
6. Any expenditure incurred on the extension or addition to an existing asset is considered as a capital expenditure.

CAPITAL AND REVENUE RECEIPTS:

In this chapter we have discussed only one aspect of a business concern--the spending of money for the acquisition of assets and services. Now the other aspect is receipt of money from various sources. When the business receives money it is again of two sorts. It my be a long-term receipt, a contribution by the owner, either to start the business off or to increase the funds available to it. It might be a mortgage or loan which brings money into the business for a long-term, but in this case it is not the owner of the business but some other investor who is supplying the money.

On the other hand, the receipt may be a short-term receipt, one which is truly a profit of the business. It may be rent received, commission received or cash for sale of goods made that day, or at some previous time.

CAPITAL RECEIPT:

Receipts which are non-recurring (not received again and again) by nature and whose benefit is enjoyed over a long period are called "*Capital Receipts*", *e.g.* money brought into the business by the owner (capital invested), loan from bank, sale proceeds of fixed assets etc. Capital receipt is shown on the liabilities side of the Balance Sheet.

REVENUE RECEIPT:

Receipts which are recurring (received again and again) by nature and which are available for meeting all day to day expenses (revenue expenditure) of a business concern are known as "*Revenue Receipts*", e.g. sale proceeds of goods, interest received, commission received, rent received, dividend received etc.

Distinction between Capital Receipt and Revenue Receipt:

Revenue Receipt	Capital Receipt
1. It has short-term effect. The benefit is enjoyed within one accounting period.	1. It has long-term effect. The benefit is enjoyed for many years in future.
2. It occurs repeatedly. It is recurring and regular.	2. It does not occur again and again. It is non-recurring and irregular.
3. It is shown in profit and loss account on the credit side.	3. It is shown in the Balance Sheet on the liability side.
4. It does not produce capital receipt.	4. Capital receipt, when invested, produces revenue receipt e.g. when capital is invested by the owner, business gets revenue receipt (i.e. sale proceeds of goods etc.).
5. This does not increase or decrease the value of asset or liability.	5. The capital receipt decreases the value of asset or increases the value of liability e.g. sale of a fixed asset, loan from bank etc.
6. Sometimes, expenses of capital nature are to be incurred for revenue receipt. e.g. purchase of shares of a company is capital expenditure but dividend received on shares is a revenue receipt.	6. Sometimes expenses of revenue nature are to be incurred for such receipt e.g. on obtaining loan (a capital receipt) interest is paid until its repayment.

IMPORTANCE OF DISTINGUISHING BETWEEN THE TWO TYPES OF EXPENDITURE AND RECEIPT:

It may be recalled that one of the fundamental concepts of accounting is "Matching Concept". By the term "Matching Concept" we mean that revenues (revenue receipt) of the relevant accounting period should be matched against expenses (revenue expenditure) or the costs of the same period to ascertain the true profit or loss made by the business. It may be stated in the form of an equation, Revenues (revenue receipt) - Expenses (revenue expenditure) = profit or loss.

Hence, the importance of making distinction between 'capital' and 'revenue' items cannot be under estimated because it vitally affects the fundamentals of accounting. If any revenue expenditure is wrongly treated as capital expenditure or any revenue receipt is treated as capital receipt and vice versa, the result of the business will not be true and fair.,

Nowadays, in most countries, an annual check-up on the business is required by law, to discover how profitable it has been. This is necessary because every government is an interested party in the business, wanting to collect tax from the proprietors and companies. In order to ensure that the owner arrives at a fair and accurate profit figure, the accountant is required by law to abide by certain rules and regulations in preparing the Final Accounts figure.

At the root of these rules lie the distinction between capital and revenue receipts and expenditure. If any revenue expenditure is left out while ascertaining profit, the profit will be overstated and if any revenue receipt is left out, then the profit will be understated and as a result, the Income Tax Authorities will be cheated of the government's lawful share.

CAPITAL AND REVENUE PROFITS:

CAPITAL PROFIT:

Capital profit is a profit which is earned on the sale of a fixed asset or profit earned on raising capital for a company (by issuing shares at premium). This is not a regular profit of the business and is not earned in the ordinary trade of the business. For example, if a machinery having book value of Rs. 50,000 is sold for Rs. 60,000, the profit of Rs. 10,000 will be a capital profit. In the same way, a joint stock company issues shares of Rs. 2,00,000 at a premium of Rs. 10,000 to raise capital, such premium of Rs. 10,000 will be a capital profit.

In this connection the distinction between capital receipt and capital profit may be noted. A machinery of Rs. 50,000 is sold for Rs. 60,000. Here capital receipt is Rs. 60,000 and capital profit is Rs. 10,000. This type of profit is not recurring and regular. It will be shown on the liability side of the Balance Sheet under the head "Capital Reserve".

REVENUE PROFITS:

This is a profit which is earned during the ordinary course of business e.g. profit on sale of goods, rent received, interest received etc.

CAPITAL AND REVENUE LOSSES:

CAPITAL LOSS:

This is a loss suffered by a business on the sale of a fixed asset or it is incurred on raising capital of a joint stock company. This is not a recurring loss and is not made in the ordinary course of the business. e.g. A machinery having book value of Rs. 50,000 is sold for Rs. 45,000, the loss of Rs. 5,000 is a capital loss. In the same way, a company issued shares of Rs. 1,00,000 at 10% discount, the loss of Rs. 10,000 (10% of Rs. 1,00,000) is a capital loss. Capital loss is sown in the Balance Sheet on the asset side as a fictitious asset which is gradually written off out of the profits every year.

REVENUE LOSS:

This loss is made in the ordinary course or day to day operation of a business such as loss on sale of goods etc. Revenue loss appears in the profit and loss account or income statement in the year in which it occurs.

CAPITAL AND REVENUE PAYMENTS

It may be noted that there is a difference between an expenditure and payment. Expenditure is the full amount spent by a business whether paid or yet to be paid while payment means the amount actually paid. For example, a machinery is purchased for Rs. 50,000 from Saleem & Co., Rs. 30,000 were paid to them in cash, agreeing to pay Rs. 20,000 after one month. In this case, total amount spent is Rs. 50,000 but the payment is Rs. 30,000 only.

CAPITAL PAYMENT:

This is an amount which is actually paid on account of a capital expenditure.

REVENUE PAYMENT:

This is an amount which is actually paid on account of some revenue expenditure. For example, we purchase goods of Rs. 30,000, this is a revenue expenditure of Rs. 30,000. We paid cash to the supplier only Rs. 20,000, this is a revenue payment. If the whole amount is paid in cash, then both the revenue expenditure as well as revenue payment will be Rs. 30,000.

ILLUSTRATION NO. 3

Do you consider the following to be capital or revenue items? Give reasons.

1. **Amount contributed by the proprietor as his capital.**
2. **Amount realised from sale of old furniture.**
3. **Money borrowed from a bank to acquire fixed assets.**
4. **Amount received from a debtor whose account was previously written off as bad.**
5. **Rs. 20,000 received from sale of old machinery which had cost Rs. 12,000.**
6. **A motor car, whose book value is Rs. 8,000 was sold for Rs. 60,000.**
7. **Received Rs. 2,00,000 from the sale of shares of a company.**
8. **Expenses on issue of shares amounted to Rs. 2,500.**
9. **Plant and Machinery which stood in books at Rs. 7,50,000, included a machine at book value of Rs. 1,50,000. This being obsolete was sold off for Rs. 50,000 and was replaced by a new machine which costs Rs. 2,40,000.**
10. **The fixtures and fittings appeared in the books at Rs. 75,000. Of these some portion of the book value of Rs. 15,000 was discarded and sold off for Rs. 16,000 and new furniture was acquired for Rs. 12,000.**

Solution:

No.	Nature of Items	Reasons
1.	Capital Receipt.	Amount contributed by the proprietor in his business is a capital receipt because the benefit of this receipt will be enjoyed for a long-period of time by the business.
2.	Capital Receipt.	When furniture was purchased it was a capital expenditure, therefore, the sale of furniture will be a capital receipt now.
3.	Capital Receipt.	Money is borrowed to acquire fixed assets, that will benefit the business for many years, so it is a capital receipt.
4.	Revenue Receipt.	When debtor's account was previously written off, it was treated as a revenue loss (expenditure), now, amount received from him will be treated as a revenue receipt.
5.	(a) Rs. 20,000, Capital Receipt (b) Rs. 8000, Capital Profit.	Furniture of Rs. 12,000 was sold for Rs. 20,000 and there was a profit of Rs. 8,000. Therefore, Rs. 20,000 is a Capital Receipt and the profit of Rs. 8,000 is regarded as Capital Profit.
6.	(a) Capital Receipt Rs. 60,000 (b) Capital loss Rs. 20,000	A motor car of the book value of Rs. 80,000 is sold for Rs. 60,000 and so there is a loss of Rs. 20,000. The full amount received Rs. 60,000 is a capital receipt and loss of Rs. 20,000 is a capital loss, because this is not a loss which occurred in the ordinary course of the business.
7.	Capital Receipt	Amount received from sale of share is a capital receipt because it will benefit for a long-period of time.
8.	Capital Expenditure.	Amount spent on issue of shares is a capital expenditure because it is incurred to raise the capital of the business.
9.	(a) Capital Receipt Rs. 50,000 (b) Capital Expenditure Rs. 2,40,000.	Amount received on sale of a portion of plant and machinery is treated as capital receipt (Rs. 50,000) and Rs. 1,00,000, the difference between the book value of the machine sold and the amount realised on sale will have to be charged off to revenue as depreciation. Rs. 2,40,000, the cost of new machinery is treated as a capital expenditure.
10.	(a) Capital Receipt Rs. 16000 (b) Capital Profit Rs. 1,000 (c) Capital Expenditure Rs. 12,000	Rs. 1,000, the difference between the book value of fixtures and fitting discarded and the amount received on sale of them will be treated as capital profit and Rs. 12,000, the cost of new fixture etc. is a capital expenditure. The total value realised Rs. 16,000 from sale is treated as a capital receipt.

TEST YOUR KNOWLEDGE

1. **In each of the following cases indicate the alternative you consider to be correct:**

(a) A loss is a revenue loss because:

(i) It is related to current assets.

(ii) It is incurred to decrease the tax liability.

(iii) It arises due to normal reasons.

(b) A loss is a capital loss because:

(i) It arises due to abnormal reasons.

(ii) It is another name given to drawing out of capital.

(iii) It relates to fixed assets.

(c) A receipt is a revenue receipt because:

(i) The amount is small.

(ii) It relates to routine activity of the business.

(iii) It is received in the accounting year.

(d) A receipt is a capital receipt because:

(i) The amount is heavy.

(ii) It is credited to capital account.

(iii) It relates to fixed assets.

(e) An expenditure is a revenue expenditure because:

(i) It is intended to benefit the current period.

(ii) The amount involved is small.

(iii) It is deducted from the gross sale proceeds.

(f) An expenditure is a capital expenditure because:

(i) The amount involved is heavy.

(ii) It is the personal expenditure of the owner out of his capital.

(iii) It is intended to benefit the future period.

Ans: *{(a), i, (b) iii, (c) ii, (d) iii, (e) i, (f) iii}*

2. **Indicate the alternative you consider correct:-**

(a) A sum of Rs. 5,000 paid as wages to repair office furniture should be debited to:

(i) Repairs Account, (ii) Cash Account,

(iii) Furniture Account.

(b) Rs. 5,000 paid as wages for erecting a machine should be debited to:

(i) Cash Account (ii) Wages Account

(iii) Machinery Account.

(c) Heavy expenditure on advertisement of a new product is a:

(i) Capital Expenditure (ii) Revenue Expenditure

(iii) Deferred Revenue Expenditure.

(d) Second-hand furniture worth Rs. 10,000 was purchased, repairing of the furniture costs Rs. 1000. The furniture was installed by the own workers wages for this being Rs. 200. The furniture should be debited for:

(i) Rs. 10,000 (ii) Rs. 11,000, (iii) Rs. 11,200.

(e) Expenditure incurred on erecting a machinery is:

(i) Revenue Expenditure (ii) Capital Expenditure

(iii) Deferred Revenue Expenditure.

Ans: *{(a) Repair A/c (b) Machinery A/c (c) Deferred Revenue Expenditure (d) Rs. 11,200 (e) Capital Expenditure}*

QUESTIONS

1. How do you distinguish between Capital Expenditure and Revenue Expenditure.
2. Explain briefly the principles for determining Capital Expenditure and Revenue Expenditure.
3. Why is the distinction between Capital and Revenue items is important in Accounting.
4. What is the difference between Deferred Revenue Expenditure and Capitalised Expenditure? Give five examples of both.
5. Distinguish between; (a) Capital and Revenue Receipts (b) Capital and Revenue Profits.

PROBLEMS

1. **State with reasons whether the following items of expenditure are capital or revenue:**

(a) Carriage paid on goods purchased.

(b) Carriage paid on machinery purchased.

(c) An amount of Rs. 20,000 paid on painting a new factory.

(d) Wages paid to workers for erection and installation of machinery.

(e) Repairs to a motor truck purchased second-hand.

2. **Do you consider the following items of expenditure to be Capital or Revenue? Give reasons.**

(i) Expenditure on advertising compaign.

(ii) Freight and carriage paid on a newly-purchased machine.

(iii) An amount spent as legal expenses for abuse of trade mark.

(iv) A classroom was constructed for the college students at a cost of Rs.50,000.

(v) Land purchased for college building at a cost of Rs. 10,00,000.

(vi) Rs. 5000 paid, for legal expenses in connection with purchase of land.

3. Show by giving reasons whether the following items of expenditure are Capital or Revenue.

(i) Rs. 50,000 paid to the Government as excise duty.

(ii) Spent Rs. 50,000 in the construction of railway sidings.

(iii) The cost of registration of newly-formed limited company.

(iv) An amount of Rs. 2,000 was paid as compensation to a discharged employee.

(v) Legal expenses incurred in raising a debenture loan.

4. State with reasons whether the following items of expenditure are Capital or Revenue.

(a) Legal expenses incurred in defending a suit for breach of contract to supply goods.

(b) A second-hand motor car was purchased for Rs. 70,000 and Rs. 5,000 were spent on its repair and overhauling.

(c) The college building was whitewashed at a cost of Rs. 5000.

(d) A new machinery was purchased for Rs. 50,000 and Rs. 1,000 was spent for its installation.

(e) Books were purchased for college library for Rs. 50,000 and Rs. 500 were paid for carrying the books to the library.

(f) Rs. 10,000 were paid for custom duty and freight on machinery imported from Germany.

5. Show by giving reasons whether the following items of expenditure are Capital or Revenue.

(a) Old furniture was repaired at a cost of Rs. 2,000.

(b) A billiard table was bought for Rs. 3,000 and Rs. 100 were paid for carrying it to the club.

(c) A sum of Rs. 5,000 was paid on account of clearing charges and customs duty in respect of a machinery bought from England.

(d) An old machine was purchased for Rs. 60,000 and Rs. 2,000 were immediately spent on overhauling and installing it.

(e) Legal expenses Rs. 500 were incurred in connection with purchase of club building.

6. State with reasons whether the following items of expenditure are Capital Revenue or Deferred Revenue.

(i) A large sum of Rs. 50,000 was spent on advertising a new product.

(ii) Medicines were purchased for Rs. 50,000 and Rs. 1,000 were spent on carrying them to the hospital.

(iii) Sports materials were purchased worth Rs. 10,000 and transportation charges Rs. 500 were paid.

(iv) Boundary walls were constructed by a college at a cost of Rs. 40,000.

(v) Freight and cartage on the new machine Rs. 300 and erection charges Rs.400.

(vi) Rs. 5,000 were paid for the removal of stock from old works to new works.

7. The following expenses are incurred during a year in respect of your college building. State with reasons whether they should be treated in the books as Capital or Revenue Expenditure.
   (a) Addition of a new wing to the library Rs. 1,00,000.
   (b) Repair to the students common room Rs. 1,000.
   (c) Whitewashing the entire building Rs. 2,000.
   (d) Money spent on electric fittings and air-conditioning the library Rs.30,000.

8. Would you consider the following chargeable to Capital or Revenue? Give reasons for your answers.
   (a) Cost incurred for obtaining a mortgage against a long-term debt.
   (b) Premium given for lease.
   (c) Commission on issue of debentures.
   (d) Discount on issue of debentures.
   (e) Expenditure incurred on renovation of the old building.
   (f) Cost of registration of a newly-formed limited company.
   (g) Legal expenses incurred for checking abuse of our trade mark by others.
   (h) Expenditure incurred on the construction of temporary huts which were necessary for the construction of a cinema hall.
   (i) Repair necessitated by negligence and lack of care and attention.
   (j) Cost of experiment which did not prove success.

Ans: *[Capital: [a, b, c, d, e, f, h, j, Revenue : [g, i]*

9. Classify the following items into capital and revenue:
   (a) Purchase of furniture, (b) Repair to machinery, (c) Payment of salaries,
   (d) Whitewashing expenses, (e) Depreciation, (f) Purchase of newspapers,
   (g) Sale of old furniture, (h) Sale of old newspapers,
   (i) Advertising compaign to launch a new product,
   (j) Repair to machinery purchased second-hand,
   (k) Cost of erecting new machinery,
   (l) Extension of building, (m) Registration expenses for purchase of land,
   (n) Expenses for removal of factory from old place to a new and better place.

Ans: *[Capital: a, g, i, j, k, l, m, n]*
[Revenue: b, c, d, e, f, h]

10. Explain with reasons whether the following items relating to a sugar mill company are capital or revenue:
   (a) Rs. 25,000 were the amount of premium was received on the issue of shares.
   (b) A motor truck costing Rs. 30,000 and standing in the books at Rs.14,500 was sold for Rs. 24,000.
   (c) Legal expenses incurred in raising a debenture loan amounting to Rs. 15,000.
   (d) Legal expenses incurred in an action for infringement of its trade mark.
   (e) Profit realised on the sale of investment Rs. 10,000.
   (f) Labour welfare expenses incurred Rs. 20,000.
   (g) Subsidy received from state Government Rs. 50,000.
   (h) Rs. 40,000 received from an issue of further shares, the expenses of issue being Rs. 5,000.
   (i) Rs. 1,50,000 being cost of land purchased for agriculture farm and Rs.900 paid for land revenue.
   (j) Rs. 3,00,000 paid for excise duty on sugar manufactured.

(k) Rs. 1,00,000 invested in Government loan.

(l) Rs. 1,20,000 spent on the construction of railway sidings.

(m) The company received Rs. 2,500 as commission for acting as an agent for the Government.

(n) A machinery standing in the books at Rs. 3,00,000 was sold for Rs.2,20,000.

Ans: *[(a) Capital profit, (b) Capital profit Rs. 9,500, Capital receipt Rs. 24,000, (c) Capital expenditure, (d) Revenue expenditure, (e) Capital profit, (f) Revenue expenditure, (g) Revenue receipt, (h) Rs. 40,000 capital receipt, Rs. 5,000 deferred revenue expenditure, (i) Capital expenditure Rs. 1,50,000, Revenue expenditure Rs. 900, (j) Revenue expenditure, (k) Capital expenditure, (l) Capital expenditure, (m) Revenue receipt (n) Capital loss Rs. 80,000, Capital receipt Rs. 2,20,000]*

11. Explain by giving reasons whether the following items of expenditure and receipt are Capital or Revenue.

(i) Profit on sale of shares held by a firm.

(ii) Replacement expenditure of a worn out part of machinery.

(iii) Compensation paid to an employee for injury caused during his employment.

(iv) Legal expenses incurred in an income tax appeal.

(v) Wages paid to workers for manufacturing goods.

(vi) Amount spent on the purchase of patent right.

(vii) Interest paid on loan borrowed for business.

(viii) Amount spent on the uniform of factory workers.

(ix) Purchase of lease-hold land.

(x) Preliminary expenses incurred on the formation of a new company.

(xi) Legal expenses in purchasing landing property.

(xii) Regular fee paid to the legal Advisor of the company.

12. The Moon Textiles Limited company have removed their factory to a more suitable place: State which items are chargeable to Capital and which to Revenue.

(a) They spent Rs. 50,000 on dismantling, removing and reinstalling plant, machinery and fixtures and fittings.

(b) A sum of Rs.10,000 was spent on removing stock from old place to new one.

(c) They spent Rs. 150,000 on purchasing land and Rs. 5000 for its registration fee.

(d) They paid Rs. 12000 to consultants for making layout plans of the factory.

(e) Plant and Machinery having book value of Rs. 100,000 were sold for Rs.40,000 being obsolete and new machinery was acquired for Rs.150,000.

(f) An amount of Rs. 5000 was spent on painting the new factory.

13. Pass the Journal entries under the following cases:

(a) Purchased goods for resale purposes for Rs. 50,000.

(b) Carriage paid on goods Rs. 500.

(c) Purchased a machinery for Rs. 100,000.

(d) Carriage paid on machinery Rs. 2000.

(e) Octroi duty paid on machinery Rs. 500.

(f) Wages paid for the installation and erection of machinery Rs. 2500.

(g) Old machinery was repaired at a cost of Rs. 1000.

(h) Old machinery having book value of Rs.40,000 was sold off for Rs.37500.

NC

CHAPTER - 13

FINANCIAL STATEMENTS

FINANCIAL STATEMENTS

Financial information is conveyed to users in a variety of reports (statements) and schedules. There are so many parties who are interested in these reports, e.g. owner, management, creditors, research scholars, Government authorities etc. Generally, reports to internal users (management) are specially designed to meet their particular needs. Reports to external users tend to be more standardized and are often referred to as "**Financial Statements**". Traditionally, two principal statements are prepared for business concerns:-

(a) An income statement (Trading a Profit and Loss A/c) which is prepared to ascertain the net income (net profit) or net loss of the business for a specific accounting period and

(b) *A balance sheet, which is* prepared to know the financial position of a business on a particular date.

INCOME STATEMENT:

An income statement shows the results of operating for a period of time. It is sometimes called an operating statement or statement of operations, It shows how well an organisation performed during the period covered.

The terms, revenue, expense and profit should be somewhat familiar to you already. *Revenue* is the inflow of assets in return for services performed or products delivered during a period; an *expense* is a sacrifice, or cost, incurred to generate (produce) revenue; *net profit* is simply the amount by which the revenues for a particular period of time exceed the expenses incurred to generate them.

Revenues generally considered earned when services are performed or goods are sold, regardless of when money is actually received. In other words, revenues are identified with the period in which they are earned. For example, a retail trader earns 'revenue' when a sale is made on credit. A right to receive money is recongnized as an "*account receivable*". An account receivable (Debtor A/c) is an asset that will eventually be converted to cash.

Expenses are also recognized in the period that is benefited, regardless of when payment is made in cash. For example, salaries earned by employees are considered an expense of the period in which employees work, even though they may not be paid in cash until the following period.

Thus the amount by which the revenues for a particular period of time exceed the expenses incurred to generate them is called net income (net profit).

For example suppose during the month of January, a trader has a total revenue (sales) of Rs. 55,000 and has incurred total expenses of Rs. 46000, his net income will be Rs. 9000 (55000-46000) for the month of January.

Thus an income statement is a statement in which revenues for a period of time are matched with expenses for the same period of time. If revenues exceed the expenses, the result is *net income,* and if expenses exceed the revenues, the result is *net loss.*

The format of an income statement varies with the needs of users, preferences of accountants and other circumstances. The format of a common income statement is given below.

NAME OF BUSINESS

INCOME STATEMENT

for the year ended........

	Rs.	Rs.	Rs.	Rs.
Sales			525000	
Less: Sales Discounts		6500		
Sales returns & allowances		8500	15000	
Net sales				510,000
Less cost of goods sold:				
Merchandise inventory (opening)			35000	
Purchases		320000		
Less: Purchase discounts	5000			
Purchase returns & allowances	3000	8000		
Net Purchases		312000		
Plus: Carriage Inwards		12500		
Delivered cost of net purchases			324500	
Cost of goods available for sale			359500	
Less Merchandise Inventory (closing)			37500	
Cost of goods sold				322000
Gross profit				188000
Less operating expenses:				
Salaries			91600	
Advertising			7000	
Depreciation			8500	
Total operating expenses				107100
Net operating income:				80900
Plus: other revenue:				
Commission received				2500
				83400
Less other expenses: interest:				900
Net income:				82500

DIFFERENT ITEMS OF INCOME STATEMENT

1. **SALES:**

It is the gross amount of goods sold or services performed during an accounting period.

2. **NET SALES:**

When sales discount, sales returns and allowances to customers are deducted or subtracted from sales (Gross Sales), the result is '*net sales*'.

3. COST OF GOODS SOLD:

It represents the sum of the costs of all goods which have been sold during the accounting period. It is ascertained by adding the value of unsold goods at the beginning of the year (opening inventory or stock) to the purchases made during the year and the deducting the values of unsold goods at the end of the year (closing inventory or stock) from the purchases. These are expired costs, and thus are actually expenses for the year.

It must be noted that purchases price of goods includes not only the cost price of goods but also all expenses connected with the purchases, such as freight inwards carriage, wages, customs duty etc. These expenses are collectively known as Direct Expenses. In determining cost of goods sold net purchases are taken into account. When all direct expenses are added to the purchase price of goods and purchases returns are deducted from purchases, the result is *net purchases*:

So, the schedule of cost of goods sold will be as follows;

COST OF GOODS SOLD:

Merchandise Inventory (goods) opening		xx
Add: Purchases	xx	
Less returns & allowances and discount	xx	
	xx	
Add: Direct expenses:	xx	xx
Cost of goods available for sale		xxx
Less: Merchandise Inventory (closing)......		xx
Cost of goods sold:		xx

For example, suppose:

(a)	Merchandise inventory on 1st Jan. 1991 was	Rs. 9100
(b)	Purchases during the year, 1991	Rs. 170,000
(c)	Purchases returns.	Rs. 2000
(d)	Purchases discount and allowances:	Rs. 1000
(e)	Transportation inwards	Rs. 5000
(f)	Customs duty etc.	Rs. 7000
(g)	Merchandise Inventory on 31st December, 1991	Rs. 10300

The cost of goods sold will be determined in the following way:

Merchandise inventory on 1.1.1991		Rs. 9100
Add purchases.....	170,000	
Less purchases returns:	2000	
	168000	
Less Purchases discount and allowances.	1000	
	167000	
Add: Direct expenses (5000 + 7000)	12000	179000
Cost of goods available for sale		188100
Less Merchandise inventory on 31.12.1991		10300
Cost of goods sold....		177800

4. GROSS PROFIT:

Merchandisers (Traders) naturally try to sell goods at a price more than the cost price. *Gross profit or gross margin,* is what remains after cost of goods sold is deducted from net sales. This is the margin that is available to cover the other expenses for a period and to yield net income, if there is any.

G.P = Net sales -- Cost of goods sold:

5. OPERATING EXPENSES:

Merchandising (Trading) concerns incur operating expenses in addition to cost of goods sold. So, the expenses which are incurred for the generation of revenues from the sales of goods are called *Operating expenses.* Operating expenses may be divided into two:

(a) Selling Expenses:

All expenses regarding sale of goods and sending them to the buyers belong to this class. e.g. Carriage outwards, Advertisements, Salesmen's Salaries, Salesmen's Commission, Travelling Expenses, Bad debts, Packing expenses etc.

(b) Administrative Expenses:

All expenses connected with the office and its conduct are called 'Administrative expenses' e.g., office salaries, office rent, electric charges, postage & Telegrams, Telephones, Printing & Stationery etc.

6. NET OPERATING INCOME:

Operating expenses are deducted from gross profit to arrive at net operating income. Net *operating income* is what is left after both cost of goods sold and operating expenses for a period have been deducted from net sales. For a merchandising concern, it is what has been earned from the normal operations of buying and selling merchandises.

Net operating Income = Gross profit - Operating expenses.

Or Net operating Income = Net sales - Cost of goods sold - Operating expenses:

7. OTHER REVENUES AND EXPENSES:

Non-sales revenues (which have not been earned by selling merchandise) and non-operating expenses are reported towards the bottom of an income statement under the heading, *other revenues and expenses.* Included in other revenues are revenue from rentals (rent received), Interest income (interest received), gain on sales of assets other than merchandise and other miscellaneous revenue items. Under other expenses are interest on borrowed money, losses on sales of assets other than merchandise, and other non-operating expenses and losses.

8. NET INCOME:

Other revenues are added to and other expenses are deducted from, net operating income to arrive at net income. N*et Income* is what is left after the other revenues have been added to net operating income and other expenses have been deducted from it.

Net Income = Net operating income + other revenues - other expenses

Or Net Income = Net Sales - Cost of goods sold - operating expenses

+ other revenues - other expenses.

SERVICE ENTERPRISES:

Service enterprises are the business concerns which are engaged to perform or provide services only. They do not deal with the purchase and sale of merchandise (goods). Their major source of revenue is fees, commission, rent or interest etc. which they receive from their customers or clients against the services provided to them. For example, Dectors, Lawyers, chartered firms, workshops etc.

The income statement for a service enterprise is prepared in the same way as we prepare for merchandising concerns except that the nature of revenues and expenses is different.

BALANCE SHEET:

Balance sheet shows the financial position or condition of an organisation at a particular point in time. In fact, it is sometimes referred to as a *position statement or a statement of condition.*

It shows the economic resources (properties, possessions) of an organisation, referred to as assets, and the claims that creditors and owners have against the assets. Economic obligations of an organisation (amount owed to creditors) are called *liabilities,* and owners' claims are referred to as *owners' equity, or capital,*

A common arrangement of the balance sheet is to list assets on the left side and liabilities and owner's equity on the right. This balances arrangement, with assets and equities (liabilities) side by side, is sometimes referred to as the *account form of balance sheet,* because it resembles the traditional T-form of an account.

An alternative arrangement, sometimes called the report form of balance sheet, centres the asset section under the heading, with the equity claims shown below the asset. The report form frequently fits on a standard sheet of paper better than the account form.

You may recall that assets are normally listed on a balance sheet in the order of their relative nearness to cash. For example, the Accounts Receivable (Sundry Debtors) account usually follows the cash account because the accounts receivable are likely to turn into cash very soon. On the other hand, assets like Land and Buildings are normally listed towards the end, because they are expected to be around a long time. So, the balance sheet that divides its accounts into subgroups within the major sections of the statement is called, *a classified balance sheet.* Generally assets are divided into two groups, current and non-current. Current assets are cash and other assets that are relatively close to being cash. In practice, an asset is classified as current if it can meet any of the following conditions within the year:

(a) If it can reasonably be expected to turn into cash.

(b) If it can easily be converted to cash by the managers of the entity.

(c) If it can take the place of cash (as with prepaid expenses).

When assets are divided into current and non-current groups, it is common practice to classify liabilities in a similar way. *Current liabilities* are liabilities that can reasonably be expected to be paid within one year. Naturally, the liabilities that are not expected to be paid within one year are referred to as *non-current liabilities*:

The format of a Balance Sheet in report form is given below:

NAME OF BUSINESS...

Balance sheet as at...

	Rs.	Rs.	Rs.
Assets:			
Current:			
Cash		2580	
Accounts receivable		2180	
Supplies		1520	
Total current assets:			6280
Non current:			
Land		6000	
Building	48000		
Less: accumulated depreciation	14800	33200	
Total non-current assets			39200
Total Assets			45480
Liabilities			
Current:			
Accounts payable and interest payable:	790		
Wages Payable:	50		
Total current Liabilities			840
Non-Current and owner's Equity			
Notes Payable (Bills Payable)		10000	
Owner's equity (capital):		34640	44640
Total liabilities and owner's equity.			45480

DIFFERENCE BETWEEN INCOME STATEMENT AND TRADING AND PROFIT AND LOSS ACCOUNT:

Both income statement and trading and profit and loss account are prepared to ascertain the net result of the business concerns. Some business concerns who have adopted British Accounting System, prepare Trading and profit and loss account to determine the net results of the business, while some others who have adopted American Accounting System, prepare income statement for the same purpose. Different terms are used under the two systems of accounting. Some American terms are given below which are equivalent to British terms.

British Accounting System		American Accounting system
1.	Bad Debts	Uncollectable accounts
2.	Provision for doubtful debts	Allowances for doubtful accounts
3.	Sundry Debtors	Accounts Receivable
4.	Sundry Creditors	Accounts payable
5.	Closing Stock of goods	Closing inventory of Merchandise
6.	Opening stock of goods	Opening inventory of Merchandise
7.	Gross profit	Gross income
8.	Net profit	Net income
9.	Trading and profit and loss A/c	Income statement
10.	Bills receivable	Notes Receivable
11.	Bills payable	Notes payable
12.	Capital	Owner's equality
13.	Income	Revenue
14.	Purchases on credit	Purchases ona ccount
15.	Company	Corporation.

EFFECT OF ADJUSTMENT ON FINANCIAL STATEMENTS

Now a days majority of the business enterprises are preparing their financial statements in statement form. The adjustments and their effect on final accounts have been discussed in detail in chapter No.11. Now in this chapter effect of adjustments on income statement is discussed to meet the requirements of modern business.

1. OUTSTANDING EXPENSES:
OR
ACCRUED EXPENSES:

(a) If the outstanding Expenses are non-recurring i.e., direct expenses:

Outstanding Expenses

Added to Net Purchases in cost of goods sold schedule in income statement

Shown in the Balance sheet under the head of current liabilities

Look at the Income Statement given below:

INCOME STATEMENT

			Rs.	Rs.	Rs.
COST OF GOODS SOLD:					
	Net purchases		×××		
Add:	Wages	××			
"	Outstanding wages	××	×××		

(b) If the outstanding expenses are recurring i.e. operating expenses:

Outstanding Expenses

Deducted from Gross Income under the head of operating expenses in income statement

Shown in the Balance sheet under the head of current liabilities

Look at the income statement given below:

INCOME STATEMENT

		Rs.	Rs.	Rs.
OPERATING EXPENSES:				
Office & Administration Expenses:				
Salaries	× ×			
Add: Outstanding Salaries	× ×	× × ×		

2. PREPAID EXPENSES OR UNEXPIRED EXPENSES OR EXPENSES PAID IN ADVANCE:

Unexpired Expenses

Expenses expired are deducted from Gross Income under the head of operating expenses in Income Statement.

Unexpired expenses are shown in the Balance Sheet under the head of current assets.

INCOME STATEMENT

		Rs.	Rs.	Rs.
OPERATING EXPENSES:				
Office & Administration Expenses:				
Rent Expired	× ×			

3. ACCRUED REVENUE OR REVENUE RECEIVABLE:

Accrued Revenue

Added to Operating Income under the head of Other Revenues in Income Statement

Accrued revenue is recorded as current asset in Balance Sheet.

INCOME STATEMENT

	Rs.	Rs.	Rs.
OPERATING INCOME:			×××
Add: **Other Revenues**			
Rental Revenue		××	
Add: Accrued Rental Revenue		××	×××

4. UNEARNED REVENUE OR REVENUE RECEIVED IN ADVANCE:

Unearned Revenue

- Revenue earned is added to operating income under the head of other Revenues in Income Statement
- Unearned revenue is shown in Balance Sheet under the head of Current Liabilities.

INCOME STATEMENT

	Rs.	Rs.	Rs.
OPERATING INCOME:			×××
Add: **Other Revenues:**			
Commission earned			××

5. DEPRECIATION OF ASSETS

Depreciation

- Deducted from Gross Income under the head of operating Expenses in income statement
- Shown under the head of Fixed Assets in Balance Sheet "as deduction from the concerned asset".

INCOME STATEMENT

	Rs.	Rs.	Rs.
OPERATING EXPENSES:			
Office & Administration Expenses:			
Depreciation on Buildings	×××		

Note: (i) If Depreciation Expense is given on debit side of Trial Balance then it is recorded only in Income Statement under the head of Office & Administration Expense.

(ii) If Accumulated Depreciation is given on credit side of Trial Balance then this balance is added in current year's depreciation and total balance is deducted from concerned balance sheet.

6. INTEREST ON CAPITAL:

Interest on Capital

Deducted from operating income under **the head of Financial** & other expenses in **Income statement**

Shown on the Liability side of Balance Sheet "as addition to capital"

INCOME STATEMENT

	Rs.	Rs.	Rs.
OPERATING INCOME:			×××
Less: **Financial & Other Expenses:**			
Interest on Capital			×××
			×××

7. INTEREST ON DRAWINGS:

Interest on Drawings

Added to operating income under the head of other Revenues in Income Statement

Added to Drawings and total Drawings are deducted from capital on Liability side of B/S.

INCOME STATEMENT

	Rs.	Rs.	Rs.
OPERATING INCOME:			×××
Add: **Other Revenues:**			
Interest on Drawings			×××
			×××

8. CLOSING INVENTORY:

Closing Inventory

- Deducted from cost of goods available for sales in income Statement
- Shown as current Asset in Balance Sheet

INCOME STATEMENT

	Rs.	Rs.	Rs.
COST OF GOODS SOLD:			
Cost of goods available for sale		×××	
Less: Closing Inventory		××	×××

Note: If closing Inventory is given in Trial Balance then it is recorded as a current asset only in Balance Sheet.

9. ALLOWANCES FOR UNCOLLECTIBLES:

Allowances for Uncollectibles

- In selling Expenses bad debts/ uncollectibles are added to Allowance for uncollectible required and from total balance existing Allowance for uncollectible is deducted.
- In Balance Sheet Allowance for uncollectible required is deducted from Accounts Receivables

INCOME STATEMENT

		Rs.	Rs.	Rs.
OPERATING EXPENSES:				
Selling & Distribution Expenses:				
Allowance for uncollectible required	×××			
Add: Uncollectibles given in T/B	××			
Add: Uncollectibles given in Adjustments	××			
	×××			
Less: Existing Allowance for uncollectibles	××			
		×××		

ILLUSTRATION NO. 1

From the following Trial Balance of Rehman and Sons, prepare an income statement for the year ended 31st December, 1990 and a balance sheet as at that date:

	Dr. Rs.	Cr. Rs.
• Cash at Bank:	80000	
• Accounts Receivable	250000	
• Merchandise inventory on 1.1.1990	150,000	
• Land	110,000	
• Building	600,000	
• Accumulated depreciation Building		220,000
• Accounts payable		120,000
• Notes payable (long-term)		200,000
• Owner's Equity (capital)		290,000
• Drawings	50,000	
• Sales		2150,000
• Sales Discounts	20,000	
• Sales Returns and Allowances:	30,000	
• Rent Revenue		50,000
• Purchases:	1300,000	
• Purchases Discounts		10,000
• Purchases Returns and Allowances		20,000
• Transportation Inwards	50,000	
• Salaries expenses	350,000	
• Advertising expenses	30,000	
• Utilities expenses	40,000	
	3060000	3060000

ADJUSTMENTS:

1. Closing Merchandise Inventory was Rs. 70,000.
2. Depreciate Building by Rs. 20,000.

Solution:

REHMAN AND SONS

Income Statement

For the year ended 31st December, 1990:

	Rs.	Rs.	Rs.	Rs.
Sales			2150000	
Less: Sales discounts		20000		
Sales Returns and allowances:		30000	50000	
Net sales				2100000
Less Cost of goods sold:				
Merchandise inventory on 1.1.90			150000	
Purchases:		1300000		
Less: Purchase discounts	10000			
Purchases Returns and allowances	20000	30000		
Net purchases		1270,000		
Plus: Transportation Inwards		50000		
Delivered Cost of net purchases			1320000	
Cost of goods available for sale			1470000	
Less: Merchandise inventory 31.12.90			70000	
Cost of goods sold				1400000
Gross profit				700000
Less: operating expenses:				
Salaries			350000	
Advertising			30000	
Utilities			40000	
Depreciation			20000	
Total operating expenses:				440000
Net operating income				260000
Add: Other revenue				
Rent				50000
Net Income				310000

REHMAN AND SONS
BALANCE SHEET
as at 31.12.1990

	Rs.	Rs.	Rs.
Assets:			
Current:			
Cash at Bank		80000	
Accounts Receivable		250000	
Merchandise Inventory on 31.12.90		70000	400000
Non-current:			
Land		110000	
Building	600000		
Less-Accumulated depreciation	240000		
		360000	470000
Total Assets			870000
Liabilities:			
Current:			
Accounts Payable:			120000
Non-current:			
Notes payable (long-term)		200000	
Owner's equity:	290000		
Add net income	310000		
	600000		
Less: Drawings	50000		
Total owner's equity		550000	750000
Total liabilities and owner's equity:			870000

ILLUSTRATION NO. 2

The following Trial Balance has been extracted from the books of Saeed and Co. on 31.12.1991. From this, prepare an income statement for the year ended 31.12.1991 and a Balance Sheet as at 31.12.1991.

	Dr. Rs.	Cr. Rs.
Cash	37080	
Accounts Receivable	52320	
Notes Receivable	24000	
Merchandise Inventory on 1.1.1991	31650	
Prepaid Insurance:	4800	
Prepaid rent	4395	
Store supplies	1650	
Furniture and fixtures	13500	
Accumulated depreciation - furniture:		3000
Office equipment	11700	
Accumulated depreciation - office equipment		4500
Accounts Payable		28600
Owner's Equity		96,000
Drawings	4500	
Purchases	180,000	
Sales:		289200
Sales Returns and allowances:	6000	
Purchases Returns and allowances:		2500
Freight Inwards and customs duty:	5750	
Sales Salaries	34200	
Advertising expenses:	3795	
Delivery expenses:	2850	
Office expenses:	3510	
Office Salaries	3000	
Interest Income		900
	424700	424700

ADJUSTMENTS:

1. Merchandise Inventory on 31.12.1991 was 40,000.
2. Rent expired during the year Rs. 2800.
3. Insurance expired during the year Rs. 2500.
4. Outstanding Sales salaries Rs. 2100.
5. Interest Receivable Rs. 200.
6. Stores supplies inventory on 31.12.1991 was Rs. 650
7. Depreciate Furniture and Fixtures by 10% p.a. and office equipment by 20% p.a.
8. Create allowance for uncollectibles at Rs. 600.

Solution:

SAEED AND CO.
INCOME STATEMENT
for the year ended 31st December, 1991

	Rs.	Rs.	Rs.	Rs.
Sales Revenue (gross)			289200	
Less Sales Returns and allowances:			6000	
Net Sales Revenue				283200
Cost of Goods Sold:				
Merchandise inventory 1.1.1991		31650		
Purchases:	180000			
Plus: Freight and customs duty	5750			
Delivered cost of Merchandise		185750		
Less: Returns and allowances:		2500		
Cost of net purchases:			183250	
Cost of goods available for sale			214900	
Less: Merchandise inventory (closing)			40000	
Cost of goods sold				174900
Gross profit				108300
Operating Expenses:				
Selling expenses:				
Sales Salaries		34200		
Outstanding Sales Salaries		2100		
Advertising expenses		3795		
Delivery expenses		2850		
Allowance for uncollectibles:		600	43545	
General and Admn expenses:				
Office expenses:		3510		
Office salaries		3000		
Rent expense		2800		
Insurance expense		2500		
Stores supplies used		1000		
Depreciation - Furniture and Fixture		1350		
Depreciation - Office Equipment		2340	16500	
Total expenses:				60045
Net operating income				48255
Add: Other revenue: Interest				1100
Net Income				49355

SAEED AND CO.
BALANCE SHEET
as at 31.12.1991

	Rs.	Rs.	Rs.
Assets:			
Current:			
Cash		37080	
Accounts Receivable	52320		
Less: Allowance for uncollectible:	600	51720	
Notes Receivable		24000	
Marchandise inventory on 31.12.1991		40000	
Prepaid Insurance:		2300	
Prepaid Rent		1595	
Interest Accrued		200	
Store supplies inventory on 31.12.1991		650	
Total current Assets			157545
Non-Current:			
Furniture & Fixture	13500		
Less: accumulated depreciation	4350	9150	
Office Equipment	11700		
Less: accumulated depreciation	6840	4860	
Total non-current Assets			14010
Total Assets:			171555
Liabilities:			
Current:			
Sales salaries payable:		2100	
Accounts payable:		28600	
Total current Liabilities			30700
Owner's Equity			
Capital		96000	
Net Income	49355		
Less: Drawings	4500	44855	
Capital on 31.12.1991			140855
Total Liabilities and Owner's Equity:			171555

ILLUSTRATION NO. 3

The following Trial Balance was extracted from the books of AB & Co. on 31.12.1989:

	Rs.		Rs.
Purchases	10944	Capital	11,380
Sales Return	120	Mortgage Loan	4,000
Opening Inventory	4396	Accounts Payable	1300
Discount on Sales	260	Sales	25,360
Office Equipment	14,000	Purchases Returns	130
Accounts Receivables	4,500	Interest	1,520
Cash in hand	415	Allowances for uncollectible	300
Salaries	1305		
Rent	1200		
Furniture	2,000		
Advertisement	2150		
Insurance	900		
Wages	950		
Uncollectibles	250		
Commission	600		
	43,990		43,990

Adjustments:

1. Rent paid in advance Rs. 350
2. Accrued Interest Rs. 120
3. Outstanding Salaries Rs. 295
4. Depreciate Equipment at 10 % & Furniture at 20 %.
5. Closing Inventory was valued at Rs. 7500.
6. Allowance for Uncollectible is maintained at 5 % on accounts receivable.

Required: Draw up an Income Statement and a Balance Sheet as on 31.12.1989.

Ans:

AB & CO.
Income Statement
For the year ended 31st December 1989

References	Amount Rs.	Amount Rs.	Amount Rs.
Sales Revenue		25360	
Less: Sales Returns	120		
" Discount on Sales	260	380	
Net Sales			24,980

Less: **Cost of Goods Sold:**				
Opening Inventory			4396	
Add: Purchases		10,944		
Less: Purchases Returns		130		
Net Purchases		10,814		
Add: Wages		950		
Delivered cost of Net Purchases			11,764	
Cost of goods available for sale			16,160	
Less: Closing Inventory			7500	8660
Gross Income				16,320
Less: **Operating Expenses:**				
Selling & Distribution Expenses:				
Insurance		900		
Advertisement		2150		
Allowances for Uncollectible:				
Allowance for uncollectible required	Rs. 225			
Add: Uncollectibles	Rs. 250			
	Rs. 475			
Less: Existing Allowance for uncollectible	Rs. 300	175		
Commission		600	3825	
Office & Administration Expenses:				
Salaries	Rs. 1305			
Add: Outstanding Salaries	Rs. 295	1600		
Rent	Rs. 1200			
Less: Prepaid Rent	Rs. 350	950		
Depreciations				
On Furniture	Rs. 400			
On Office Equipment	Rs. 1400	1800	4250	8075
Operating Income				8245
Add: **Other Revenues:**				
Interest			1520	
Add: Accrued Interest			120	1640
Net Income				9885

AB & Co.
Balance Sheet
As on 31st December 1989

	Rs.	Rs.	Rs.
ASSETS:			
Current Assets:			
Cash in hand		415	
Prepaid Rent		350	
Accrued Interest		120	
Closing Inventory		7500	
Accounts Receivables	4500		
Less: Allowance for Uncollectibles	225	4275	
Total current assets			12660
Fixed Assets:			
Office Equipment	14000		
Less: Depreciation	400	12600	
Furniture	2000		
Less: Depreciation	400	1600	
Total fixed Assets			14200
Total Assets			26860
LIABILITIES:			
Current Liabilities:			
Accounts Payable		1300	
Outstanding Salaries		295	
Total Current Liabilities			1595
Fixed & Long Terms Liabilities:			
Mortgage Payable		4000	
Capital	11380		
Add: Net Income	9885	21,265	
Total Fixed & long term Liabilities			25265
Total Liabilities			26860

ILLUSTRATION NO. 4

The following trial balance is extracted from the books of Hafiz & Co. on 31.12.1990:

	Rs.		Rs.
Land & Building	10,000	Accounts Payable	2800
Office Equipment	6,000	Loan from ICP	7000
Inventory	3,000	Bills Payable	1000
Drawings	650	Return Outward	1100
Carriage In	250	Sales	25000
Cash in hand	335	Commission received	400
Loan to Ahmad	4,500	Capital	12000
Bills Receivable	2450		
Salaries	1,740		
Accounts Receivable	3,200		
Rent & Taxes	640		
Wages	360		
Postage	200		
Delivery Charges	300		
Sales Salaries	1200		
Interest on Loan	275		
Purchases	14,200		
	49,300		49,300

ADJUSTMENTS:

1. Closing Inventory was valued at cost Rs. 5500 market value Rs. 6200.
2. Outstanding wages Rs. 200 and salaries Rs. 400.
3. Rent prepaid Rs. 150.
4. Depreciation on fixed assets at 5 % p.a.
5. Commission unearned Rs. 150.
6. Create an allowance on Accounts Receivable at 5 % for Uncollectibles.

Required: Prepare an Income Statement and Balance Sheet as on 31.12.1990

Ans:

HAFIZ & CO.
Income Statement
For the year ended 31st December 1990

References		Amount Rs.	Amount Rs.	Amount Rs.
Sales Revenue				25000
Less: **Cost of Goods Sold:**				
Opening Inventory			3000	
Add: Purchases		14200		
Less: Return outward				
		1100		
Net Purchases		13,100		
Add: Carriage In		250		
Wages	Rs. 360			
Add: Wages Outstanding	Rs. 200	560		
Delivered cost of Net purchases			13,910	
Cost of goods available for sale			16,910	
Less: Closing Inventory				11,410
			5,500	
Gross Income				13,590
Less: **Operating Expenses:**				
Office & Administration Expenses:				
Salaries	Rs. 1740			
Add: Salaries Outstanding	400	2140		
Rent & Taxes	Rs. 640			
Less: Prepaid Rent	150	490		
Postage		200		
Depreciations:				
On Land & Building	Rs. 500			
On Office Equipment	300	800	3,630	
Selling & Distribution Expenses:				
Delivery Charges		300		
Sales Salaries		1200		
Allowances for uncollectibles		160	1660	5290
Operating Income				8300
Add: **Other Revenues:**				
Commission received			400	
Less: Unearned Commission			150	250
Less: **Financial & other Expenses:**				8550
Interest on Loan				275
Net Income				8275

HAFIZ & CO.
Balance Sheet
As on 31st December 1990

	Rs.	Rs.	Rs.
ASSETS:			
Current Assets:			
Cash in hand		335	
Bills Receivable		2450	
Accounts Receivable	3200		
Less: Allowances for uncollectible	160	3040	
Loan to Ahmad		4500	
Closing Inventory		5500	
Prepaid Rent		150	
Total Current Assets			15975
Fixed Assets:			
Land & Building	10,000		
Less: Depreciation	500	9500	
Office Equipment	6000		
Less: Depreciation	300	5700	
Total Fixed Assets			15200
Total Assets			31,175
LIABILITIES:			
Current Liabilities:			
Accounts Payable		2800	
Bills Payable		1000	
Unearned Commission		150	
Outstanding Wages		200	
Outstanding Salaries		400	
Total Current Liabilities			4550
Fixed & Long Term Liabilities:			
Loan from ICP		7,000	
Capital	12,000		
Less: Drawings	650		
	11,350		
Add: Net Income	8275	19625	
Total Fixed & long term Liabilities			26625
Total Liabilities			31,175

QUESTIONS

1. What do you mean by Financial Statements? Why are these statements prepared?
2. What do you mean by cost of goods sold? How is it determined?
3. Explain and give the format of Income Statement, Balance Sheet and Cost of Goods Sold.

PROBLEMS

1. Ascertain the cost of goods sold from the following particulars:

		Rs.
(i)	Opening Merchandise Inventory	19500
(ii)	Purchases (gross)	150,000
(iii)	Purchases Discounts	3500
(iv)	Purchases returns and allowances	2900
(v)	Freight Inwards	7000
(vi)	Customs duty and clearing charges	2700
(vii)	Closing Merchandise inventory	30900

Ans: *[Cost of goods sold = Rs. 141900]*

2. Ascertain the gross income from the following particulars:

	Rs.
Purchases during the year, 1990	350,000
Purchases discounts	3700
Purchases returns and allowances:	2050
Sales: 470,000	
Sales discount	1500
Sales returns and allowances:	2200
Merchandise inventory on 1.1.1990	50500
Merchandise inventory on 31.12.1990	30,800
Transportation Inwards:	9500

Ans: *[Gross Income Rs. 92850]*

3. The following balances are extracted from the books of Asif & Bros. for the year ended 31st December, 1991. You are required to prepare an income statement for the year ended 31.12.1990.

	Rs.
Merchandise inventory on 1.1.90	36000
Purchases	140,000
Purchases discounts	3000
Purchases returns and allowances	2500
Sales	175000

Sales discounts	1200
Sales returns and allowances	1600
Carriage inwards	800
Wages:	1500
Sales Salaries	15000
Advertising expenses:	9600
Utilities expenses:	7000
Insurance:	950
Rent, rates and taxes	2300
Commission to salesmen:	1900

The Merchandise inventory on 31.12.1990 was valued at Rs. 53000:

Ans: *[Gross profit Rs. 52400; Net income Rs. 15650]*

4. The following Trial Balance was extracted from the books of Naeem & Sons on 31st March, 2000. From this you are required to prepare an income statement for the year ended on 31.3.2000 and a Balance Sheet as at that date:

Trial Balance On 31.3. 2000

	Dr. Rs.	Cr. Rs.
Cash	5000	
Account Receivable	9000	
Merchandise inventory on 1.4.1989	6000	
Plant and Machinery	24000	
Land and Building	82000	
Furniture and Fixtures	2600	
Capital:		136000
Accounts payable		3800
Purchases:	60,000	
Purchases returns and allowances		2200
Discount on purchases:		600
Sales:		70,000
Sales returns and allowances	3000	
Sales Discount	1600	
Insurance prepaid:	3400	
Advertisement expenses	4000	
Salaries expenses:	12000	
	212600	212600

ADDITIONAL INFORMATION:

1. Prepaid insurance on 31.3.2000 is Rs. 1400
2. Outstanding salaries Rs. 1000.
3. Depreciation on plant and machinery @ 10% p.a.
4. Merchandise inventory on 31.3.2000 was valued at Rs. 6000.

Ans: *[G.P. Rs. 8200, Net loss Rs. 13200; B/S 127600]*

5. The following are the balances extracted from the books of Usman Traders as at 31st December, 2000;

	Rs.		Rs.
Inventory (1.1.2000)	45,270	Capital	555,400
Drawings	4,550	Accounts payable	45,750
Buildings	400,000	Allowances for uncollectible	4,125
Office Equipment	100,000	Rent received	21,125
Cash in hand	29,150	Discount	2,850
Cash at bank	116,540	Sales	392,470
Accounts Receivable	69,750	Purchases Return	12,280
Prepaid Advertisement	10,150	9% bank loan	42,000
Purchases	232,710		
Sales Returns	5,540		
Carriage in	7,825		
Salaries	37,875		
Travellers commission	3,940		
Office Expenses	4,500		
Discount	2,150		
Insurance	4,270		
Interest on loan	1,780		
	1076,000		1076,000

ADJUSTMENTS:

1. Merchandise Inventory at 31.12.2000 was valued at Rs.25470.
2. Prepaid advertisement Rs.3520; insurance unexpired Rs.2140.
3. Interest on bank loan is outstanding.
4. Allow interest on capital at 5% p.a. & 3% on drawings.
5. Depreciate building at 5% and equipment at 10%.

Req: Prepare Income Statement and Balance Sheet.

Ans: *[G.I. Rs.138875, N.I. Rs.48336.5, B/s Rs.716570]*

6. The following Trial Balance has been extracted from the books of Nazir & Co. on 31.12.2000. From this prepare an Income Statement and Balance Sheet:

	Rs.		Rs.
Cash at Bank	30,000	Accounts payable	55,000
Accounts Receivable	45,090	Owner Equity	130,000
Bills Receivable	15,450	Drawings	5,500
Merchandise Inventory	31,400	Purchases	146,200
Unexpired Insurance	4800	Sales	225,000
Repair Charges	3600	Sales Returns	3400
Telephone Charges	6000	Purchases Returns	2890
Fixtures	20,000	Customs duty	5700

Business Premises	65,000	Sales Salaries	10,800
Depreciation fund	7,500	Advertisement	5400
Office Salaries	12,350	Office Expenses	1350
Interest Income	790	Delivery Charges	2150
Wages	7080		

ADJUSTMENTS:

1. Closing inventory is valued at Rs. 54000.
2. Depreciate fixed assets by 10 %.
3. Write off Rs. 3000 as uncollectibles and make allowance for uncollectible at 5 % on accounts receivable and allowance for discount on accounts receivable at 2 %.
4. Interest earned but still receivable Rs. 410.
5. A bill receivable Rs. 4500 not yet due was discounted on 20th December, 2000.

Ans: *[Gross Income Rs. 88110, Net Income Rs. 33262, B/S Rs. 228,762]*

7. On 31st December 2000, the following Trial Balance was extracted from the books of Kashif Traders:

Furniture	65,000	Rent	32,500
Sales Ledger Balance	74,750	Salaries	18,100
Merchandise Inventory on 31.12.2000	42,500	Bought ledger balance	61,750
		Income Tax	950
Purchases Adjusted	181,400	Bank overdraft	18,350
Cash in hand	8,220	Sales	296,450
Freight	4,370	Capital	98,000
Taxes and Insurance	8,000	Allowance for uncollectible	2,950
Carriage on sales	2,910	Sales salaries	24,160
Utilities charges	10490	Accountancy fee	4,150

ADJUSTMENTS:

1. Taxes outstanding Rs.2000; Insurance unexpired Rs.500.
2. Write off Rs.750 as uncollectibles and make an allowance for uncollectible at 5 % on receivables.
3. Reserve for discount on debtors and creditors at 2 %.
4. Goods costing Rs.5000 were taken by Kashif for his personal use, for which no record has been kept.

Req: Prepare Income Statement and Balance Sheet.

Ans: *[G.I. Rs.115680, N.I. Rs. 12,199, B.S. Rs.185,114]*

8. From the following Trial Balance prepare Trading and Profit & Loss A/c / Income statement for the year ending 30th June 2001 and a Balance Sheet as at that date.

	Dr.	Cr.
Capital		105,600
Plant & Machinery	143,375	
Purchase (less returns)	122,625	
Sales (less returns)		294,400

Opening Inventory	59,500	
Debtors and Creditors	62,375	45,750
Salaries & Wages	16,540	
Trade Expenses	750	
Rent & Insurance	12,250	
Bad Debts	1,460	
Allowance for Uncollectible		1,250
10% Govt. securities (1.1.2001)	49,550	
Rent payable		750
Depreciation on Plant & Machinery	11,625	
Cash at bank	19,950	
Commission		8,250
12% Bank loan (1.10.2000)		44,000
	500,000	500,000

ADJUSTMENT:

1. Closing Stock valued at cost Rs.42,500 (Market value Rs.45,000).
2. Goods costing Rs.10,000 destroyed by fire. Insurance Co. admitted the claim for a loss of Rs.6,250.
3. Commission received in advance Rs.4750.
4. Raise bad debts provision to 4% of debtors.
5. A bill receivable Rs.5000 not yet due was discounted on 15th June,2001.

Ans: *[G.I. 164775, N.I. 119173, B/s 323983]*

9. From the following particulars prepare financial statements for the year ending 1st December 2001.

	Dr.	Cr.
Cash in hand	9,730	
Cash at bank	39,748	
Stock on 1.1.2000	59,552	
Wages	4,750	
Royalty	1,040	
Octori duty	3,660	
Purchases & Sales	215,170	352,750
Returns Inward	5,430	
Returns Outward		2,250
Rent	7,950	
Salaries	25,450	
Goodwill	20,000	
Plant & Machinery	24000	
Debtors & Creditors	115,500	51,640
Bad Debts	3,760	
Provision for bad debts		4,355
Loan to Mr. X	16,260	
Rent by sub–letting		5,155

Liabilities for expenses		1,250
Loan from Mr. Y		14,800
Capital		120,550
Bank Charges	750	
	552,750	552,750

ADJUSTMENT:

1. Closing stock was valued at Rs.51,250.
2. Increase bad debts provision by 5% on sundry debtors.
3. Closing stock included Rs.11,450 worth of goods received for which the invoice was not received.
4. Manager is entitled to a commission of 10% on net profit after charging such commission.

Ans: *[G.I. 105198, N.I. 64025, B/s 271118]*

10. The following are the balances extracted from the books of Waseem Traders as at 31st December, 1998:

	Rs.		Rs.
Capital	110,000	Traveller's Commission	8,450
Drawings	6,500	Rent Recovered	2400
Buildings	80,000	Cash in hand	1450
Furniture	30,000	Cash at bank	5000
Equipments	10,000	Accounts Receivable	40,500
Purchases	169,600	Accounts Payable	35,200
Purchases Returns	2400	Advertisement	3,200
Sales	273,500	Discount (Dr.)	750
Sales Returns	3500	Office Expenses	2100
Inventory (1.1.98)	32,210	Addition to Building	5000
Salaries	28,000	General Charges	3400
Freight out	2,000	Bank Overdraft	9,450
Printing & Stationery	3500	Excise Duty	1250
Uncollectibles	650	Insurance	1640
Allowances for Uncollectible	3,500	Packing Exp.	1110
Discount (Cr.)	3360		

ADJUSTMENTS:

1. Goods taken by Waseem for his household use were Rs. 3500.
2. Advertisement was paid up to 31st March 1999.
3. Depreciation on building 2 % on furniture 5 % and on equipment 10 % p.a.
4. Charge interest on capital at 10 %.
5. Closing inventory was valued at Rs. 40,000.
6. Allowances for uncollectible to be made upto Rs. 3500.

Prepare Income Statement and Balance Sheet as on 31st December 1998.

Required: Prepare financial statements.

Ans: *[Gross Income Rs. 112,840 Net Income Rs. 49500 B/S Rs. 205150]*

11. From the following information, prepare Income Statement and Balance Sheet as at 31.12.1997 after taking into account the following adjustments.

(a) Closing Inventory has ben valued at Rs. 2400.

(b) Goods worth Rs. 1500 have been taken by the proprietor for his private use.

(c) One quarter of insurance premium falls in the next year.

(d) Depreciation is charged on furniture at 10 % p.a.

(e) Allowance for uncollectible is maintained at 5 %.

	Rs.		Rs.
Cash in hand	3480	Rent by Sub-letting	200
Discount	240	Sales	29480
Furniture	1200	Discount	120
Goodwill	2000	Allowances for uncollectible	400
Uncollectible	200	Liabilities for Expenses	760
Wages	40	Rent payable	40
Insurance	240	6 % Loan from Y (1.1.1997)	2000
Advertisements	1200	Return Outward	200
Accounts Receivable	12000	Capital	16000
Purchases	24000	Accounts Payable	5200
Inventory on 1.1.97	2400		
Carriage Inward	400		
Carriage Outward	200		
Returns Inwards	320		
8 % Loan to X on 1.7.1997	1200		
Salaries	2400		
Rent	480		
Drawings	2400		
	54400		54400

Ans: *[Gross Income Rs. 6420 Net Income Rs. 1448 B/S Rs. 21668]*

12. The Balance Sheet items for Mughal Autos were as follows at June 30, 1994:

	Rs.		Rs.
Accounts Payable	4000	Land	40,000
Accounts Receivable	300	Notes Payable	46,000
Building	20,000	Supplies	2,800
Cash	4600	Saleem Mughal's Capital	?
Equipment	26,000		

During the next three days, the following transactions occurred:

July 1: Saleem invested an additional Rs. 15000 cash in the business. Half of the accounts payable were paid. A note payable amounting to Rs. 6,000 was also paid.

July 2: Equipment was purchased at a cost of Rs. 9,000 to be paid within ten days. Supplies were purchased for Rs. 500 in cash.

July 3: Some repair work was completed for which an amount of Rs. 700 is to be received within next week.

Required: (a) Balance Sheet as on June 30, 1994.
(b) Balance Sheet as on July 03, 1994.

Ans: *[(i) B/S Rs. 93700 (ii) B/S Rs. 110400]*

13. From the following information prepare an income statement for the year ended 31st December 1998 and a Balance Sheet as on that date:

	Rs.		Rs.
Capital	120,000	Repairs & Renewals	1800
Accounts Payable	15,200	Buildings	54,000
Bills Payable	1,000	Office Equipment	35,000
Commission Payable	2,300	Furniture	10,000
Sales	618,000	Carriage Outward	1,250
Discount Received	1,100	Packing Expenses	2,150
Inventory	95,000	Advertisement	11,400
Purchases	468,000	Prepaid Insurance	5,400
Carriage Inward	8,900	Travelling Expenses	2,300
Sales Salaries	750	Cash in hand	2,250
Accounts Receivable	50,000	Allowances for uncollectible	2,000
Uncollectibles	1,400		
Salaries	10,000		

Inventory as on 31st December 1998 was valued at Rs. 109,000. Office Equipment is to be depreciated at Rs. 3100 Buildings at 7.5 % and Furniture at 15 %. Allowances for uncollectible is to be created at 5 % on accounts receivable. Allowance for discount on Accounts Receivable at 2 %. Insurance prepaid Rs. 2400, salaries payable Rs. 500.

Ans: *[Gross Income Rs. 155100 Net Income Rs. 111550 B/S Rs. 250550]*

14. The following Trial Balance has been extracted from the books of A & B who are sharing profit & loss in the ratio of 3:2 on 31st December, 1998:

	Rs.		Rs.
Merchandise Inventory	40,000	Capital A	100,000
Discount on Sales	750	B	70,000
Accounts Receivable	72,000	Accounts Payable	46,000
Wages	14,500	Bank Overdraft	24,000
Furniture	28,000	Sales	222,000
Office Equipment	35,000	Discount on Purchases	1400
Cash in hand	6,250	Allowances for uncollectible	4,000
Purchases	174,500		

Uncollectibles	2,600	
Drawings A	12,000	
Drawings B	9,000	
Coal, Gas & Water	8,600	
Rent & Rates	10,600	
Postage	2,400	
Office Supplies	15,800	
Commission	8,900	
Sales Salaries	26,500	
	467400	467400

ADJUSTMENTS:

1. Closing Inventory was valued at cost Rs. 95000.
2. Office Supplies were valued at Rs. 7,500 on 31.12.1998.
3. Raise allowance for uncollectible by 5 % on Accounts Receivable.
4. Wages outstanding Rs. 1500.
5. Rent and rates prepaid Rs. 4000.
6. Interest Rs. 3000 accrued on overdraft.

Required: Prepare an Income Statement for the year ended 31st December 1998 and Balance Sheet as on that date.

Ans: *[Gross Income Rs. 78550 Net Income Rs. 19250 B/S Rs. 242750]*

15. Some of the items of Assets, Expenses, Liabilities and Revenues appearing in the Trial Balance are given as under:

	Rs.		Rs.
Prepaid Insurance	1200	Unearned Management Fees	24000
Office Supplies	1000	Capital	60,000
Building	24000		
Accounts Receivable	12600		
Salaries Expenses	9700		

From the following additional information you are required to record the adjusting Journal entires and show how these adjustments will affect the financial statements.

(a) Insurance expenses of the period were Rs. 1000.

(b) Office Supplies in hand at the close of the period were valued at Rs. 300.

(c) Three-Fourth of the Management work was completed till the close of the period.

(d) Salaries of the office worker amounting to Rs. 300 were yet to be paid.

(e) Write off Rs. 600 as bad debts and raise an allowance for uncollectibles equal to 5 % of the Accounts Receivable.

(f) Allow 5 % interest on capital.

16. Following is the Trial Balance of a firm. From this you are required to prepare an income statement for the year ending on 31st December, 2000 and a Balance Sheet as on that date.

Trial Balance On 31.12. 2000

	Dr. Rs.	Cr. Rs.
Cash at Bank	80,000	
Accounts receivable	35200	
Stores supplies	5000	
Prepaid Rent	11240	
Furniture and Fixtures	7600	
Accumulated depreciation- Furniture and Fixture		1520
Prepaid Insurance:	8500	
Plant a Machinery	45000	
Accumulated depreciation - plant and Machinery		9000
Capital:		165000
Accounts payable:		8500
Drawings	31000	
Sales revenue:		212980
Salaries expense	9500	
Advertising expense	7000	
Purchases:	95000	
Wages:	10,000	
Purchases returns		6500
Sales returns	3000	
Merchandise Inventory on 1.1.2000	45000	
Travelling expenses:	5460	
Miscellaneous expenses:	5000	
	403500	403500

ADJUSTMENTS:

1. Merchandise inventory on 31.12.2000 was valued at Rs. 35000.
2. Store supplies on hand 31. 12.2000 Rs. 1500.
3. Prepaid rent expired Rs. 9240.
4. Prepaid insurance expired Rs. 6000.
5. Depreciate furniture and fixture and plant and Machinery by 10% p.a.
6. Accrued salaries Rs. 3000.
7. Write off bad debts from accounts receivable Rs. 1500.

Ans: *[Gross income Rs. 101480; Net income Rs. 46020; B/S 191520]*

17. On 31st December 1991, the following Trial Balance was extracted from the books of a Merchant:

	Rs.		Rs.
Business Premises	80,000	Accounts Payable	8,852
Furniture	25,000	Bank Overdraft	4900
Sales Ledger Balance	35,000	Sales	131,000
Opening Inventory	20,000	Capital	95,000
Cash in hand	1,400	Allowance for uncollectible	1,450
Marketable Securities	15,000	Interest on Securities	448
Prepaid Advertisement	6,000	10 % Bank Loan	58,350
Purchases	92,500		
Freight	3,650		
Salaries	12,400		
Taxes & Insurance	1,250		
Uncollectibles	750		
Accountancy Fee	800		
General Charges	1,800		
Travelling Expenses	500		
Discount Allowed	330		
Sales Return	245		
Carriage on Sales	375		
Bills Receivable	3,000		
	300,000		300,000

ADJUSTMENTS:

1. Closing inventory was valued at Rs. 32500.
2. Advertisement expired during the year Rs. 4500.
3. Taxes outstanding Rs. 250 and Insurance paid in advance Rs. 200.
4. Interest accrued on securities Rs. 452.
5. Depreciate premises at 5 % and furniture at 10 %.
6. Interest on bank loan outstanding for six months.
7. Raise allowances for uncollectible by 5 % on Accounts Receivable.

Required: Prepare financial statements.

Ans: *[Gross Income Rs. 47105 Net Income Rs. 14832 B/S Rs. 185102]*

18. The following Trial Balance has been extracted from the Books of Sohail & Co. for the year ended on 31st December 1998.

	Rs.		Rs.
Cash at Bank	3950	Accounts Payable	32000
Accounts Receivable	65000	Capital	135000
Merchandise Inventory	40800	Sales	190000
Prepaid Rent	6650	Purchases Return	3,100
Office Supplies	7000	Allowance for uncollectibles	4,950
Furnitures & Fixture	18,000	Accumulated Depreciation	
Office Equipment	42000	On Furniture	3,600
Purchases	142000	Accumulated Depreciation	
Sales Returns	2,400	on Equipment	8,400
Royality paid	4,500	Loan from Asif	10,000
Salaries	20,300		
Postage & Telegram	3,440		
Carriage Out	2,660		
Salemen's Salaries	9,450		
Audit Fee	2,500		
Legal Charges	3,000		
Wages	4,500		
Insurance	6,500		
Uncollectibles	2400		
	387,050		387,050

ADJUSTMENTS:

1. Closing Inventory was valued at Rs. 89000.
2. Office Supplies on hand at 31.12.1998 Rs. 2500.
3. Depreciate furniture and Equipment at 10 %.
4. Rent prepaid Rs. 2450.
5. Wages payable Rs. 500; Salaries accrued Rs. 1000.
6. Raise allowances for uncollectible by $2\frac{1}{2}$ % on account receivable.
7. The manager is entitled to a commission of 10 % on the net profit after charging, such commission.

Required: Prepare an Income Statement and Balance Sheet.

Ans: *[Gross Income Rs. 87400 Net Income Rs. 20205 B/S Rs. 200725]*

CHAPTER - 15

RECTIFYING THE ERRORS

RECTIFYING THE ERRORS

We have already seen that the chief use of the trial balance is to check the accuracy of the book-keeping. The agreement of the debit and the credit totals is reasonably a good evidence that the book-keepers have done their work well, but it is not conclusive. In other words, we can reasonably assume that the books of accounts are correct if the trial balance agrees. But we cannot be absolutely sure of the accuracy of the books of accounts even if the trial balance agrees. It is so because there are certain errors which are not disclosed even if the Trial Balance agrees. In other words, the trial balance will agree inspite of the existence of those errors. For example, (i) goods sold to Mr. A for Rs. 1500 on credit. The posting will be made in two accounts, - on the debit side of Mr. A Account and on the credit side of Sales Accounts. Suppose, Mr. A account is correctly debited with Rs. 1500 but sales account is erroneously credited with Rs. 150 only.

Mr. A/c

Sales A/c	1500		

Sales A/c

		Mr. A A/c	150

As a result, Mr. A/c will show a debit balance of Rs. 1500 which will be carried forward in the debit column of the trial balance and sales A/c will show a credit balance of Rs. 150 which will be carried forward in the credit column of the trial balance and consequently *the total of credit column of trial balance will be Rs. 1350 (1500 - 150) short and obviously it will not agree.* Thus this is an error which is disclosed by the trial balance.

EXAMPLE 2

Suppose we paid salaries of Rs. 9500. This transaction will be posted on the credit side of the Cash Book and the debit side of the Salaries Account. But erroneously, we debited the Rent account instead of debiting the Salaries account. Undoubtedly, this is an error, but it will not disturb the agreement of the trial balance because the balances of both the Salaries A/c and Rent Ac are recorded in the debit column of the trial balance. Such sort of errors are never revealed by the trial balance.

ERRORS CAUSING DISAGREEMENT OF TRIAL BALANCE:

The following types of errors are detected by the trial balance.

1. DOUBLE POSTING OF A TRANSACTION FROM JOURNAL TO LEDGER:

Suppose, goods sold to M. Asif Rs. 2000 are correctly recorded in the Sales Book, but erroneously debited twice in Mr. Asif Account in the ledger. For this error, the total of debit column of trial balance will be Rs. 12000 excess.

Mr. Asif A/c

Sales A/c	12000		
Sales A/c	12000		

Sales A/c

		as per Sales Book	12000

2. WRONG POSTING OR OMISSION OF POSTING ONE ASPECT OF A TRANSACTION IN LEDGER:

Suppose, (a) we purchase goods for Rs. 5000 from H. Karim and record it correctly in purchases journal (Book), but forget to make posting on the credit side of H. Karim's A/c. Due to this error the total of credit column of Trial Balance will be Rs. 5000 short.

Purchase A/c

as per purchase Book	5000		

H. Karim A/c

		No posting	

Again, if we credit H. Karim A/c with Rs. 500 instead of Rs. 5000 by mistake, the total of credit column of the trial balance will be Rs. 4500 short.

3. **WRONG ENTRY OR OMISSION OF ENTRY IN JOURNAL BUT CORRECT POSTING IN THE LEDGER:**

Suppose, well sell goods worth Rs. 16000 to K. Khalid and debit K. Khalid A/c with Rs. 16000 in the ledger, but forget to record it in the Sales Journal (book) and consequently we make no posting in Sales A/c. For this error, the total of credit column of the trial balance will be Rs. 16000 short.

K. Khalid A/c

Sales A/c	16000		

Sales A/c

		No posting from sale journal	

Again, if we record the transaction in Sales Book as Rs. 1600 by mistake, but debit K. Khalid A/c correctly with Rs. 16000, the total of credit column of the trial balance will be Rs. 14400 short.

4. **POSTING A TRANSACTION ON THE WRONG SIDE OF AN ACCOUNT:**

Suppose, we sell goods to Sohail worth Rs. 1000 on credit basis and correctly record it in the Sales Journal, but Sohail A/c is credited with Rs. 1000 instead of being debited. For this error, the total of debit column of the trial balance will be Rs. 2000 (1000 + 1000) short. This error will cause a difference of Rs. 2000 (double) because posting is made on the wrong side of Sohail's A/c.

Sales A/c

		as per Sales book.	1000

Sohail A/c

		Sales A/c (wrong posting)	1000

5. **ERROR IN CASTING SPECIAL JOURNALS:**

Suppose, the Sales Journal (book) is cast Rs. 2000 short. For this error Sales A/c will be credited Rs. 2000 short and the total of credit column of the trial balance will be Rs. 2000 short.

SALES JOURNAL

Wrong casting of sales journal.

					Rs.
	Salim				3000
	Kalim				5000
	Manzoor				9500
					15500

6. **ERROR IN BALANCING A LEDGER ACCOUNT:**

Suppose, the balance of Kashif A/c is wrongly drawn as Rs. 10,000 (Dr.) instead of Rs. 11000 (Dr.). For this error the total of debit column of trial balance will be Rs. 1000 short.

Kashif A/c

Wrong balance is taken out

			Rs.
Sales A/c	10,000	Cash A/c	23000
Sales A/c	15,000		
Sales A/c	9000	Balance c/d	10,000
	34,000		34,000

7. ERROR OR OMISSION IN TRANSFERRING A LEDGER ACCOUNT BALANCE IN TRIAL BALANCE:

Suppose, Machinery A/c balance Rs. 50,000 is wrongly transferred to trial balance as Rs.500,000. For this error, the total of debit column of trial balance will be Rs. 450,000 (500,000 - 50,000) excess. In the same way, if machinery A/c balance is recorded wrongly on the credit column of the trial balance, the total of credit column of the trial balance will be Rs. 100,000 (50,000 + 50,000) excess. On the other hand if machinery A/c balance is not recorded at all in the trial balance, the total of debit column of the trial balance will be Rs. 50000 short.

8. CASTING ERROR OF TRIAL BALANCE:

Suppose, the debit column of the trial balance is cast Rs. 2000 short. For this error, there will be a difference of Rs. 2000 between two columns of the trial balance and the total of debit column of the trial balance will be Rs. 2000 short :

TRIAL BALANCE

Wrong casting of debit column

		Dr.	Cr.
		Rs.	Rs.
1.	Cash A/c	10,000	
2.	Purchase A/c	15,000	
3.	Sales		20,000
4.	Salaries	3000	
5.	Creditors		8000
		(26000)	28000

9. RECORDING A LEDGER ACCOUNT BALANCE TWICE IN TRIAL BALANCE:

Suppose, the balance of Rent A/c Rs. 5000 (Dr.) is wrongly recorded twice in the trial balance. For this error, the total of debit column of the trial balance will be Rs. 5000 excess.

Thus, it may be noted that all the above-mentioned errors do not let the trial balance agree and are disclosed by the trial balance.

ERRORS NOT CAUSING DISAGREEMENT OF TRIAL BALANCE:

These errors have no effect on the agreement of the trial balance and it agrees inspite of the existence of such errors. These are not detected by the trial balance and are divided into the following five groups :

1. ERRORS OF OMISSION IN ORIGINAL BOOKS OF ENTRY:

It means that a transaction has been completely omitted from the original books of accounts. If something is omitted completely from the books, it will appear neither on the debit nor the credit side of the trial balance, because both the debit and the credit aspects have been omitted from the books of accounts. For example, goods sold to Mr. Salman for Rs. 6000 have been omitted to be recorded in the Sales Journal, obviously no posting will be made on the debit side of Mr. Salman A/c and credit side of Sales A/c. For this error, the total of both the columns of trial balance will be Rs. 6000 short; so, the trial balance will agree.

2. WRONG AMOUNT RECORDED IN ORIGINAL BOOKS OF ACCOUNTS:

It means that the amount of a transaction has been wrongly recorded in the journal and the same wrong amount was also posted in the ledger. Suppose, goods sold to M. Naeem for Rs. 5000 are wrongly recorded in the Sales Journal at Rs. 500 and the same wrong amount of Rs. 500 is posted both in the M. Naeem account and in the sales account. Because of this error the total of both the columns of the Trial Balance will be Rs. 4500 (5000 - 500) short. So, the trial balance will agree.

3. ERRORS OF COMMISSION:

It means that a transaction instead of being recorded in the right account, has been recorded in a wrong account of the same class. For example, sale of goods to Amir is wrongly debited to Umar A/c instead of Amir A/c. Both Amir A/c and Omar A/c belong to the debtors account group. It is, therefore, an error of commission. For this error, there is no mistake in the amount on any side, so the trial balance will agree.

Note: Some of the errors of commission also affect the agreement of the trial balance and they can be revealed by preparing the trial balance.

4. ERRORS OF PRINCIPLE:

This mistake arises out of ignorance of the fundamental principles of accountancy. Usually this type of error occurs because of;

(a) Treating a capital expenditure as revenue expenditure and vice versa.

(b) Creating inadequate provision in respect of doubtful debts.

(c) Providing insufficient depreciation on fixed assets.

For example, repairs to furniture have been wrongly debited to Furniture A/c instead of debiting Repairs A/c It means that a transaction instead of being recorded in the right account, has been recorded in wrong account of a different class. Repair is a revenue expenditure, hence it should be debited to Repairs A/c. But it has been wrongly debited to Furniture A/c assuming it to be a capital expenditure. Since repairs A/c and furniture A/c belong to two different classes (Repairs A/c belongs to expenses A/c, while Furniture A/c belongs to Assets A/c), so it is an error of principle. For this error, there is no mistake in the amount on any side. So, the trial balance will agree.

5. COMPENSATING ERRORS:

It means that some errors in amount have occurred on the opposite sides of two or more accounts and have concealed themselves in the net result. Suppose Purchase A/c has been wrongly debited with Rs. 5000 instead of Rs. 4000. On the other hand Asif A/c has been wrongly credited with Rs.1500 instead of Rs. 1000 and Sales A/c has been credited with Rs. 6000 instead of Rs. 5500. The result is, excess debit of Rs. 1000 in Purchase A/c and excess credit of Rs. 1000 (500 + 500) in Asif A/c and Sales A/c. So, the trial balance will agree.

It should be remembered that compensating errors may individually affect the agreement of trial balance but collectively they never effect on the agreement of trial balance.

The trial balance will agree inspite of the existence of the above mentioned errors. So it is said that the trial balance is not a conclusive proof of the accuracy of accounts - it is only a prima facie evidence. Thus it can be concluded that if the trial balance does not agree, we can say definitely that there are errors in the books of accounts ; but in case the trial balance agrees, we cannot say definitely that there are no errors i.e. errors may or may not exist. Further, it is possible to detect a good number of errors through the trial balance. The accountant heaves a sigh of relief, when the trial balance agrees.

What to do when the trial balance does not agree?

If the trial balance does not agree, it is sure that there are errors in the books of accounts. So, efforts must be made to detect those errors and to make the trial balance agree. It is needless to mention here that if all the errors are detected and rectified, the trial balance must agree.

The following steps should be taken to detect the errors;

1. Check the total of both the columns of trial balance. If the difference is in round figures, i.e., 10, 100, 1000 etc. It is possible that casting is wrong.
2. Whether the cash and the bank balances have been correctly drawn and included in the trial balance.
3. Whether the total of discount columns of both the side of the cash book are correct and whether they have been correctly posted in the discount A/c.
4. Whether the balances of all the ledger accounts have been correctly included in the trial balance.
5. Whether the balances of all the debtors and creditors have been correctly included in the trial balance.
6. Whether the totals of special journals (subsidiary books) are correct and whether they have been posted correctly to the concerned ledger accounts.
7. Whether the balances of all ledger accounts have been correctly drawn.
8. Whether each item of the special journals is correctly written and whether it has been posted correctly to the concerned ledger accounts.
9. Whether each item of the cash book has been correctly recorded and posted to the concerned ledger accounts.
10. Whether each item of the journal proper has been correctly recorded and posted to the concerned ledger accounts.
11. Whether the opening balance of each account has been correctly brought down.
12. If the difference is divisible by 9, it is possible that in writing an amount the digits have been interchanged or transposed. i.e. 81 instead of 18, 917, instead of 179, 545 instead of 455, 273 instead of 372 etc.
13. Compare each item of current trial balance with corresponding figures of past year's trial balance and in case of large difference, verify the concerned figures carefully.
14. See whether there is any amount in the trial balance equal to the half of the difference. If there be such an amount, it is possible that it has been recorded on the wrong column of the trial balance.

AGREEMENT OF TRIAL BALANCE BY OPENING SUSPENSE ACCOUNT:

We have discussed different steps by which errors are detected and the trial balance is made to agree. But it may so happen that errors cannot be detected in spite of verification of all books of accounts and the trial balance is not made to agree. As we know, the trial balance is a statement on the basis of which "Final Accounts are prepared and the Final Accounts can only be prepared if the trial balance agrees. In such a case the trial balance is temporarily made to agree with help of "Suspense Account, because preparation of final accounts cannot be delayed further. This is done by recording the amount of difference of the trial balance on its lesser column under the head "Suspense Account". For this purpose a new account styled **"Suspense A/c"** will be opened in the ledger. Suspense A/c is debited if the total of Debit Column of

the trial balance is short. On the other hand Suspense A/c is credited if total of the credit column of the trial balance is short. An example is given below in which the trial balance does not agree and then it is made to agree by opening suspense account.

	Trial Balance as on 31-12-1990	Dr.	Cr.
		Rs.	Rs.
1.	Machinery A/c	1,00,000	
2.	Sundry Debtors A/c	60,000	
3.	Purchase A/c	120,000	
4.	Expanses A/c	80,000	
5.	Sales A/c		200,000
6.	Creditors A/c		80,000
7.	Capital A/c		60,000
		360,000	340,000

It may be noted that there is a difference of Rs. 20,000 between the two columns of the trial balance. The credit column is short by Rs. 20,000. Inspite of all the best efforts made by the Book-Keeper, the errors are not detected, so the trial balance is temporarily made to agree by opening Suspense A/c in the ledger. the difference of Rs. 20,000 is recorded on the lesser column (credit column) of the trial balance under the head "Suspense A/c". See the following trial balance.

	Trial Balance as on 31-12-1990	Dr.	Cr.
		Rs.	Rs.
1.	Machinery A/c	1,00,000	
2.	Sundry Debtors A/c	60,000	
3.	Purchase A/c	120,000	
4.	Expanses A/c	80,000	
5.	Sales A/c		200,000
6.	Creditors A/c		80,000
7.	Capital A/c		60,000
8.	***Suspense A/c***		***20,000***
		360,000	360,000

It must be noted that the problem will not be solved by making the trial balance agree with the help of suspense A/c, because this is a forced agreement and the errors still exist in the books of accounts. This is done only to avoid further delay in the preparation of the Final Accounts. So the books of accounts are to be checked a fresh next year and all the errors must be detected and rectified and the profit of the previous year will be adjusted accordingly. When all the errors are detected and rectified by passing entries, the Suspense A/c will be closed.

It should also be remembered that, there will be no journal entry for debiting or crediting, the Suspense A/c, because it reflects the account or accounts where the errors lie. For example, suppose the total of debit column of the trial balance is Rs. 5000 short and a Suspense A/c has been debited with Rs. 5000 to make the trial balance agree. In the ledger the Suspense A/c is opened in this way;

Suspense A/c

	Rs.		Rs.
The Difference in trial balance	5000	Furniture A/c (the error rectified)	5000
	5000		5000

Subsequently on examination of books of accounts, it is found that purchase of furniture for Rs.5000 has not been debited to furniture A/c by mistake. Thus the mistake will be rectified by passing a Journal entry in which the Furniture A/c will be debited and the Suspense A/c will be credited. In this way, the Suspense A/c will be closed.

It is useful to mention here that the extent of errors cannot be assessed by the amount of difference. In other words, the difference may be small in spite of the existence of major errors. Hence, the difference, however small it may be, must not be ignored. For example, suppose, we buy goods for Rs. 10,000, but by mistake purchase A/c has not been debited. At the same time, we receive from Mr. A. Rs. 9900 but by mistake Mr. A A/c has not been credited. For these two major errors the trial balance will differ to the extent of Rs. 100 (10,000 - 9900) only.

ILLUSTRATION NO. 1

How will the following mistakes affect the agreement of the trial balance?

(1) Goods purchased from Faisal for Rs. 5000 were wrongly recorded in the purchase book as Rs. 600 but the account of Faisal was correctly.

(2) Sales Book was under cast by Rs. 1000.

(3) A sum of Rs. 5000 received from Azhar was omitted to be posted to his account.

(4) Furniture purchased for Rs. 3000 was wrongly passed through the Purchases Book.

(5) Discount Rs. 100 allowed to Shabir was not entered in the cash book.

(6) A sum of Rs. 2000 received from X was duly recorded in the cash book but posted twice in X A/c.

(7) A sum of Rs. 6000 received from Naeem was wrongly credited to Naseem A/c.

(8) Goods purchased from Qasim Bros Rs. 5000 were wrongly debited to their account.

(9) Rent Rs. 1500 paid to Asghar-Landlord, was wrongly debited to Asghar A/c.

(10) Goods purchased from Kalim Rs. 4000 were not posted to his account.

(11) Goods sold to Mukhtar Rs. 5000 were wrongly debited to his account as Rs. 500.

(12) Salaries A/c balance Rs. 8000 was wrongly recorded in the trial balance twice.

(13) Interest A/c balance Rs. 1200 (Cr.) was not incorporated in the trial balance.

(14) Salaries A/c balance Rs. 13000 was wrongly incorporated in the trial balance as Rs. 1300.

(15) A sale of Rs. 5000 to Karim & Co. was not recorded in the sales book.

Solution :

Under-casting means under totaling

1. Only the purchase A/c is affected. The purchase account balance will be Rs. 4400 less and the debit column of trial balance will be short by Rs. 4400.
2. Only the sales A/c is affected. The sales Account balance will be Rs. 1000 less and the credit column of the trial balance will be short by Rs. 1000.
3. Only Azhar Account is affected as posting is not made on the credit side of his account. The credit column of the trial balance will be short by Rs. 5000.
4. The Furniture A/c and the Purchase A/c are affected. Furniture A/c balance will be Rs. 3000 less and the Purchase A/c balance will be Rs. 3000 in excess. This error will not affect the trial balance.
5. Only the discount A/c is affected. The discount A/c balance (Dr.) will be Rs. 100 less and the debit column of the trial balance will be short by Rs. 100.
6. Only the X A/c is affected. As the posting of Rs. 2000 is made twice on the credit side of the X A/c, so the credit column of the trial balance will be in excess by Rs.2000.
7. Naeem A/c and Naseem A/c are affected because a sum of Rs. 6000 is posted on the credit side of the Naseem A/c instead of Naeem A/c but this error will have not effect on the agreement of the trial balance.
8. Only the Qasim Bros A/c is affected. As the amount of Rs. 5000 is posted on the debit side of the Qasim Bros A/c instead of the credit side, so the effect of this error will be doubled. The debit column of the trial balance will exceed by Rs. 10,000 (5000 + 5000).
9. Rent paid should have been debited to the Rent A/c but it was wrongly debited to Asghar A/c. This is an error of principle. The trial balance is to affected.
10. Only Kalim A/c is affected as a sum of Rs. 4000 is not posted on the credit side of his A/c. The credit column of trial balance will be *short by Rs. 4000.*
11. Only Mukhtar A/c is affected. As Mukhtar A/c is debited with Rs. 500 instead of Rs. 5000, so the debit column of the trial balance will be *short by Rs. 4500 (5000-500).*
12. Nothing is wrong in Salaries A/c. The error is made in the trial balance only and due to this error the debit column of the trial balance will in *excess by Rs. 8000.*
13. Nothing is wrong in the Interest A/c, only its credit balance is not incorporated in the trial balance. Consequently, the credit column of the trial balance will be *short by Rs. 1200.*
14. Nothing is wrong in the Salaries A/c, only the wrong balance is incorporated in the trial balance i.e. Rs. 1300 instead of Rs. 13000. So, the debit column of trial balance will be *short by Rs. 11700 (13000 - 1300).*
15. As sale of goods Rs. 5000 to Karim & Co. is not recorded in the Sales Book, so neither Karim & Co. A/c is debited, nor Sales A/c is credited with the amount. Hence, this error will have *no effect on the agreement of trial balance.*

HOW THE ERROR ARE RECTIFIED?

The errors in books of accounts must first of all be located and then rectified. But the question is how to certify the errors. The errors are generally rectified through journal entries-the wrong figures must not be canceled or erased. If, however, an error is detected instantly, the wrong figure must be canceled and correct figure should be written in its place. In that case the Accountant put his initial as an authentication of cancellation and correction of the error. No clear cut rules for rectification of errors can be laid down. How an error is rectified - it depends upon the nature of the error and the stage when it is detected.

The errors may be detected in any of the following three stages.

1. Before preparation of trial balance.
2. After preparation of trial balance but before preparation of Final Accounts.
3. After preparation of Final accounts.

From the view point of rectification, the errors can be divided into two groups.

1. ERROR EFFECTING ONE ACCOUNT OR ONE SIDED - ERROR:

As we know every business transaction is posted at least in two different accounts - on the debit side of one account and on the credit side of other account. If only one account is affected or disturbed because of the error or mistake and the other concerned account/accounts are correct, such an error is know as "one-sided error." It means the transaction has been wrongly recorded (Posted) on one side (debit or credit), but correctly recorded on the other side. Generally, these errors are (a) Errors of casting (b) Errors of carry forward (c) Errors of posting (d) Omission from trial balance.

2. ERRORS AFFECTING TWO OR MORE ACCOUNTS OR TWO-SIDED ERRORS:

These are the errors due to which, two or more accounts are affected or disturbed. Such errors are as follows :

(a) Errors of omission

(b) Errors of posting to wrong account

(c) Errors of principle.

CORRECTION OF ONE SIDED ERRORS IF DETECTED BEFORE PREPARATION OF THE TRIAL BALANCE:

for the rectification of such errors, if detected before the preparation of the trial balance, no journal entries are required. Simply the required amount is put on the debit or credit side of the concerned account where the error has occurred.

ILLUSTRATION NO. 2

Rectify the following errors : One-sided errors :

1. Goods bought for Rs. 3000 from Akram were wrongly credited to his account as Rs. 300, but correctly recorded in the Purchase Book.

Solution :

This is a one-sided error as wrong amount is posted on the credit side of Akram A/c i.e. Akram A/c has been credited with R. 300 instead of Rs. 3000. On the other hand, Purchase A/c has been correctly debited with Rs. 3000. Now, the error will be rectified if Akram A/c is now credited with Rs. 2700 (3000 - 300) in the following way;

Akram A/c

			Rs.
		Purchase A/c	300

Akram A/c

			Rs.
		Purchase A/c	300
		Wrong amount posted now adjusted	***2700***

Wrong amount is posted

It may be noted that no journal entry is passed, simply Akram A/c is credited with Rs. 2700.

2. **Goods sold to Rehman for Rs. 4000 were wrongly debited to his account as Rs. 40,000, but correctly recorded in the Sales Book.**

Solution:

In this case the Sales Book has been correctly recorded, i.e, Sales A/c has been correctly credited with Rs. 4000. But Rehman A/c has been debited with Rs. 40,000 instead of Rs. 4000, i.e. debited Rs. 36000 (40,000 - 4000) more. As only the Rehman A/c is affected, so it is a one- sided error. If Rehman A/c is now credited with Rs. 36000 then the excess debit of Rs. 36000 will be canceled. So the error is rectified. There will be no journal entry.

Rehman A/c

	Rs.		
Sales A/c	40,000		

→

Rehman A/c

	Rs.		Rs.
Sales A/c	40,000	***Adjustment of wrong debit.***	***36000***

Correction of one-sided errors if detected after the preparation of the trial balance but before the preparation of the final accounts :

We have already discussed that if the trial balance does not agree, certainly there are errors in the books of accounts and the trial balance is then artificially and temporarily made to agree by putting the difference in "Suspense" A/c. Suspense A/c represents the combined effect of all the errors that have been occurred in the books of accounts.

If one-sided errors are detected after the preparation of the trial balance but before the preparation of the Final Accounts, they are always corrected with the help of rectifying journal entries.

It must be noted that all one-sided errors cause discrepancy in the trial balance, and to rectify them, there must be a suspense A/c in rectifying journal entry. Thus we can conclude that to **rectify any error which causes discrepancy in the trial balance, there must be a suspense account in the rectifying journal entry.**

As we know, one-sided error affects only one ledger account, so in the rectifying entry of such errors, two accounts are (a) wrong account which is to be corrected (b) suspense account.

See the following examples, one-sided errors :-

(a) ***Goods purchased from Naeem for Rs. 3000 were wrongly credited to his account as Rs. 300, but correctly recorded in the purchase book.***

In this case, the purchase book has been correctly recorded, i.e. Purchase A/c has been debited with Rs.3000. But Naeem A/c has been credited with Rs. 300 instead of Rs. 3000, i.e. credited Rs. 2700 (3000 - 300) less. As a result the total of credit column of the trial balance is short by Rs. 2700. So, the trial

balance has been made to agree by putting Rs. 2700 on its credit column under the head "Suspense A/c." In other words, Suspense A/c is credited with Rs. 2700 in the following way;

Suspense A/c

	Rs.		Rs.
Naeem A/c	***2700***	Difference in trial balance	2700

Naeem A/c

			Rs.
		Purchase A/c	300
		Suspense A/c	***2700***

When the error is detected and rectified the following entry is passed;

	Dr.	Cr.
Suspense Account ---------------- Dr.	2700	
Naeem Account -----------------------		2700

(Being goods purchased from Naeem for Rs. 3000, wrongly credited to his account as Rs. 3000, now rectified).

(b) Goods sold to Salman for Rs. 4000 were wrongly debited to his account as Rs.40,000 but correctly recorded in the sales book.

In this case, nothing is wrong in Sales A/c, i.e. it has been correctly credited with Rs. 4000. But Salman A/c has been debited with Rs. 40,000 instead of Rs. 4000, i.e. debited Rs. 36000 (4000 - 4000) more. As a result the total of the credit column of the trial balance is short by Rs. 36000. So, the trial balance has been made to agree by recording Rs. 36000 on its credit column under Suspense A/c. Now in rectifying entry. Suspense A/c is debited with Rs. 36000 to cancel the previous credit entry and Salman A/c is credited with Rs. 36000 to cancel the wrong debit given to his account. The rectifying entry will be;

	Rs.	Rs.
Suspense Account ---------------- Dr.	36000	
Salman Account -----------------------		36000

(Being goods sold for Rs. 4000, wrongly debited to Salman A/c as Rs. 40,000 now corrected).

The two accounts are ;

Salman A/c

	Rs.		Rs.
Sales A/c	40,000	***Suspense A/c (wrong debit rectified)***	***36000***

Suspense A/c

	Rs.		Rs.
Salman A/c	***36000***	Difference in T.B.	36000
	36000		36000

It may be noted that when an error is rectified, the Suspense A/c shows zero balance.

(c) Sales book was under cast by Rs. 2000.

In this case, the error is only in Sales A/c and all other accounts are correct, so this is a one sided error. The credit balance of Sales A/c is short by Rs. 2000 and as a result, the total of the credit column of the trial balance is short by 2000. The trial balance has been made to agree by recording Rs. 2000 on its credit column. Now the suspense A/c will be debited and the Sales A/c will be credited further with Rs. 2000 to rectify the error. The following entry will be passed;

	Rs.	Rs.
Suspense Account ---------------- Dr.	2000	
Sales Account -------------------------		2000

(Being Sales book under cast, now rectified)

Date	Sales Book			Amount
				Rs.
-	A & Co.			5000
-	X & Co.			3000
-	Naseem			3000
				9000

Wrong Casting

Sales A/c

	as per S.B. 9000
	Suspense A/c 2000
	11000

Sales A/c is rectified

(d) Purchases book was under cast by Rs. 1000

Under-casting of purchase book means, the total of purchases book is short by Rs. 1000 and in turn, amount debited to the purchases A/c is also short by Rs. 1000. As a result the total of debit column of the trial balance is short by Rs. 1000. So the trial balance has been made to agree by recording Rs. 1000 on its debit column under suspense A/c. In other words, the Suspense A/c has been debited with Rs. 1000. When the error is detected, the Suspense A/c will be credited with Rs. 1000 in order to cancel its debit entry. The rectifying entry will be;

	Rs.	Rs.
Purchase Account --------------- Dr.	1000	
Suspense Account --------------------		1000

(e) Sales Returns book was over cast by Rs. 1000:

In this case Sales Returns Book has been over cast by Rs. 1000. In other words. Sales Returns A/c (Returns inwards A/c) has been debited Rs. 1000 more. Now, this error will be rectified, if the Sales Return A/c is credited with Rs. 1000 and the Suspense A/c is debited with Rs. 1000.

	Rs.	Rs.
Suspense Account --------------- Dr.	1000	
Sales Return Account ---------------		1000

(Being sales return book overcast, now rectified)

(f) Rs. 5000 paid to Karim was omitted to be debited to his account:

In this case, Rs. 5000 have not been debited to Karim A/c. The error is only in Karim A/c. As a result of this error, the total of debit column of trial balance is short by Rs. 5000. Now this error will be rectified, if Karim A/c. is debited with Rs. 5000 and the Suspense A/c is credited with Rs. 5000.

The rectifying entry will be :

	Rs.	Rs.
Karim Account ----------------- Dr.	5000	
Suspense Account --------------------		5000

(Being the amount paid to Karim but not posted to his account, now rectified).

(g) Goods sold to Dawood for Rs. 2000 were wrongly credited to his account:

In this case, the error is only in Dawood A/c. Dawood A/c has been credited with Rs. 2000 instead of being debited. As a result of this error the total of debit column of the trial balance is short by Rs. 4000 (2000 + 2000). This error will have double effect on the trial balance, because the amount is posted on the

opposite side. So, the suspense A/c has been put with Rs. 4000 in the debit column of the trial balance to make it agree. Now, this error can only be rectified if Dawood A/c is debited with Rs. 4000, i.e. Dawood A/c debited with Rs. 2000 to cancel the wrong credit and Rs. 2000 to make him debtor. The following entry will be passed.

		Rs.	Rs.
Dawood Account ----------------	Dr.	4000	
Suspense Account --------------------			4000
(Being goods sold to Dawood for Rs. 2000 but wrongly credited to his account, now rectified).			

It may be noted that, in all the rectifying entries, one account debited or credited is suspenses account and the other account is wrong account which is being rectified. ***So for all one sided errors, whenever rectification is made, in rectifying entry , one account will be the account which is being rectified and the other account will be the suspense A/c.***

Correction of two-sided errors after preparation of the trial balance, but before the preparation of the final accounts:

These errors affect two or more accounts and are usually rectified with the help of journal entries, on whatever stage they are detected. Such errors may or may not cause disagreement in the trial balance. ***There will be no suspense A/c in rectifying journal entry, if the error does not cause any discrepancy in the trial balance and there will be suspense A/c in the rectifying journal entry, if any error causes disagreement in the trial balance.***

Errors which affect two or more accounts can be (a). Error of commission (b) errors of posting to wrong account (c) errors of principle.

To rectifying these errors, the following three aspects should be noted.

(a) What should have been the correct entry?

(b) What entry has already been passed?

(c) What should be the rectifying journal entry?

In other words, the result of wrong entry and rectifying entry should be equal to the entry which we should have passed (correct entry) :

Correct Entry = Wrong entry + Rectifying entry.

See the following examples:

1. MACHINERY PURCHASED FOR RS. 50,000 BUT THE AMOUNT WAS DEBITED TO PURCHASE A/C:

As the Machinery has been purchased, the amount should have been debited to Machinery A/c, but purchase A/c has been wrongly debited. So, the error is in two accounts i.e. in Machinery A/c which should have been debited and in the Purchase A/c which should have not been debited. This error has not caused any discrepancy in the trial balance, so there will be no question of suspense A/c in rectifying entry. This error now can be rectified, if purchase A/c is credited (to cancel the wrong debit given to purchase A/c) and machinery A/c is debited (which has not been debited previously). The rectifying entry will be;

		Rs.	Rs.
Machinery Account --------------	Dr.	50,000	
Purchase Account ---------------------			50,000
(Being purchase of Machinery wrongly debited to purchase A/c, now corrected).			

See the two accounts before and after rectification;

Machinery A/c

	Rs.		
not debited purchase A/c	50,000		

Machinery A/c Debited

Purchase A/c

	Rs.		Rs.
Wrong debit	50,000	Machinery	50,000

Purchase A/c rectified

It can be explained in the following way;

Correct entry		=	**Wrong Entry**	+	**Rectifying entry.**
Machinery A/c	Dr.	=	Purchase A/c 50,000	+	Machinery A/c 5000
Cash A/c	Cr.	=	Cash A/c 50,000	+	Purchase A/c 5000

It must be noted that correct entry has not been made in the books of accounts, only, wrong entry and rectifying entry have been passed and the combined result of these two entries will be equal to the correct entry.

2. SALARIES PAID RS. 10,000 WRONGLY DEBITED TO RENT A/C:

As Rent A/c has been debited with Rs. 10,000 instead of Salaries A/c, so this error will not cause any discrepancy in the trial balance and the suspense A/c will not find its place in rectifying entry.

Salaries A/c

	Rs.		
Rent A/c	*10,000*		

Not debited and then rectified i.e. debited

Rent A/c

	Rs.		Rs.
Cash A/c	10,000	Salaries A/c	10,000

wrongly debited and then rectified

The rectifying entry will be

		Rs.	Rs.
Salaries A/c ----------------------	Dr.	10,000	
Rent A/c ------------------------------			10,000
(Being payment of salaries wrongly debited to Rent A/c, now rectified).			

3. GOODS SOLD ON CREDIT TO ANWAR FOR RS. 5000 WERE RECORDED IN THE SALES BOOK AS RS. 500:

As the sales book has been recorded wrongly, so the amount posted on the debit side of Anwar A/c and on the credit side of Sales A/c is Rs. 500 instead of Rs. 5000. The error is in Anwar A/c and Sales A/c. It will cause no discrepancy in the trial balance, and there will be no suspense A/c in rectifying entry. The rectifying entry will be,

		Rs.	Rs.
Anwar Account ------------------	Dr.	4500	
Sales Account ------------------------			4500

(Being goods sold for Rs. 5000, wrongly recorded as Rs. 500, now corrected).

The two accounts before and after rectification.

Anwar A/c

	Rs.		
Sales A/c	500		
Sales A/c	4500		

Sales A/c

			Rs.
		as per sales Book.	500
		Anwar A/c	4500

The Anwar A/c is further debited with Rs. 4500 and Sales A/c is further credited with Rs. 4500 and both accounts are rectified.

4. GOODS PURCHASED FROM AMJAD FOR RS. 4000 WERE RECORDED IN PURCHASES BOOK AS RS. 400 AND POSTED (CREDITED) TO AMJAD A/C AS RS. 40:

Now see where the errors are made in Purchase Book. Purchase A/c and Amjad A/c,

It may be noted that the purchase A/c has been debited with Rs. 400 instead of Rs. 4000 (debited Rs. 3600 less) and Amjad A/c has been credited with Rs. 40 instead of Rs. 4000 (credited Rs. 3960 less). As, the wrong debit and credit are not equal, so there will also be a discrepancy of Rs. 360 (3960-3600) in the trial balance and the total of credit column of the trial balance will be short by Rs. 360. The suspense A/c is placed on the credit column of the trial balance with Rs. 360. Now, this error can be rectified, if the purchase A/c is further debited with Rs. 3600, the suspense A/c is debited with Rs. 360 (to close suspense A/c) and Amjad A/c is credited further with Rs. 3960. The rectifying entry will be,

		Rs.	Rs.
Suspense Account	Dr.	360	
Purchase Account	Dr.	3600	
Amjad Account			3960

(Being credit purchases for Rs. 4000 first wrongly recorded in the Purchases Book as Rs. 400 and then posted to Amjad A/c as Rs. 40, now rectified).

ILLUSTRATION NO. 3

Rectify the following errors.

1. **Goods sold to Sameer for Rs. 9000 were debited to his account as Rs.900.**
2. **Sales book was under-cast by Rs. 2500.**
3. **Rs. 10,000 received from X were not posted to his account.**
4. **Goods bought from Asim for Rs. 16000 were omitted to be recorded in the book.**
5. **Salaries paid to Rashid Rs. 6000, were wrongly debited to his account.**
6. **Goods purchased from Riaz for Rs. 12000 were wrongly credited to his account as Rs. 10,000.**
7. **Furniture purchased from Liaqat & Co. for Rs. 8000 was wrongly passed through purchases book.**
8. **Rs. 3000 received from Salim were wrongly credited to Kalim A/c.**

Solution:

1. The error is only in Sameer A/c which has been debited with R. 900 instead of Rs. 9000. So, it is a one sided error and will cause a discrepancy of Rs. 8100 (9000 - 900) in the trial balance, therefore there will be suspense A/c in rectifying journal entry. The error is rectified, if Sameer A/c is further debited with Rs. 8100. The rectifying entry will be,

	Rs.	Rs.
Sameer Account ---------------- Dr.	8100	
Suspense Account --------------------		8100
(Being Sameer A/c wrongly debited now corrected).		

2. The sales book has been under-cast by Rs. 2500, i.e. the Sales A/c has been credited less by Rs. 2500. The error is only in sales A/c and it will cause a discrepancy of Rs. 2500 in the trial balance. This error can be rectified, if sales A/c is credited further with Rs. 2500. The rectifying entry will be.

	Rs.	Rs.
Suspense Account --------------- Dr.	2500	
Sales Account -----------------------		2500
(Being Sales Book under-cast, now rectified).		

3. The error is in X A/c only, as he has not been credited with Rs. 10,000. This error will cause a discrepancy of Rs. 10,000 in the trial balance and it can be rectified, if X A/c is now credited with Rs. 10,000. The rectifying entry will be,

	Rs.	Rs.
Suspense Account --------------- Dr.	10,000	
X A/c --------------------------------		10,000
(Being amount received from X but not credited to his account, now rectified).		

4. As goods purchased from Asim has not been recorded in the books at all, so purchase A/c has not been debited and Asim A/c has not been credited. The error is in both the accounts and it will cause no discrepancy in the trial balance, so there will be no suspense A/c in the rectifying journal entry. This error can be rectified, if Purchase A/c is debited with Rs. 16000 and Asim A/c is credited with Rs. 16000. The rectifying journal entry will be,

		Rs.	Rs.
Purchases Account	Dr.	16,000	
Asim Account			16,000
(Being goods purchased, but omitted to be recorded, now rectified).			

5. Salaries paid should have been debited to Salaries A/c being expenses, but they have been wrongly debited to Rashid A/c. The error is in two accounts, i.e. Salary A/c and Rashid A/c. This error will cause no discrepancy in the trial balance, so no suspense A/c in rectifying entry. The error can be rectified now, if salaries A/c is debited (which has not been debited before) and Rashid A/c is credited (to cancel the wrong debit given to him). The rectifying entry will be,

		Rs.	Rs.
Salaries Account	Dr.	6000	
Rashid Account			6000
(Being wrong debit given to Rashid, now corrected).			

6. Riaz A/c has been credited with Rs. 10,000 instead of Rs. 12000. (Credited Rs. 2000 less). The error is only is Riaz A/c and it will cause a discrepancy of Rs. 2000 in the trial balance, so there will be a suspense A/c in rectifying entry. The error can be rectified, if Riaz A/c is credited further with Rs. 2000. The rectifying entry will be,

		Rs.	Rs.
Suspense Account	Dr.	2000	
Riaz Account			2000
(Being goods bought from Riaz for Rs. 12000, wrongly credited to his account as Rs. 10,000, now rectified).			

7. This is an error of principle. furniture purchased has been debited to the Purchase A/c instead of the furniture A/c. So, the error is in two accounts, i.e. in the purchase A/c (wrongly debited) and in the furniture A/c (which has not been debited). The error will cause no discrepancy in the trial balance and can be rectified, if the purchase A/c is credited (to cancel the wrong debit given) and the furniture A/c is debited. The rectifying entry will be,

		Rs.	Rs.
Furniture Account	Dr.	8000	
Purchase Account			8000
(Being Furniture purchased, wrongly debited to purchase A/c, now corrected).			

8. Amount received from Salim, has been wrongly credited to Kalim A/c instead of Salim A/c. The error is in two accounts, i.e. in Salim A/c (which has not bee credited) and in Kalim A/c (which has

been wrongly credited). This error will cause no discrepancy in the trial balance and can be rectified, if Kalim A/c is debited (to cancel the wrong credit given to him) and Salim A/c is debited. The rectifying entry will be,

	Rs.	Rs.
Kalim Account ------------------ Dr.	3000	
Salim Account ------------------------		3000
(Being the wrong credit given to Kalim instead of Salim, now rectified).		

ILLUSTRATION NO. 4

Following errors have been found in the books of Rizwan & Co. Give necessary entries to rectify them.

1. **Rs. 7000 paid in cash for a typewriter purchased were charged (debited) to the office expenses account.**
2. **An amount of Rs. 10,000 withdrawn by the proprietor for his personal expenses debited to trade expenses account.**
3. **Sale of goods worth Rs. 5000 to Ali was wrongly passed through the purchases book.**
4. **A credit purchase of Rs. 10,000 from Rizwan was wrongly passed through the sales book.**
5. **Goods worth Rs. 200, were returned to Kamran but no entry was passed in the books.**
6. **The casting of the sales book Rs. 115594 was carried to the sales A/c as Rs. 151954.**

Solution:

RIZWAN & CO.
Journal

	Date	Details	L/R	Dr. Amount	Cr. Amount
				Rs.	Rs.
No effect on tail balance, so no suspense A/c	1.	Type writer Account .... Dr.		700	700
		Office expenses Account			
		(Being purchase of typewriter wrongly debited to office expenses A/c now, corrected.			
No effect on trial balance, so no suspense A/c	2.	Drawing Account .... Dr.		10,000	
		Trade expenses Account			10,000
		(Being drawings wrongly treated as Trade expenses, now rectified).			
No effect on trial balance, no suspense A/c	3.	Ali Account .... Dr.		10,000	
		Sales Account			5000
		Purchase Account			5000
		Being credit sales passed through Purchase book now rectified.			

No effect on trial balance, no suspense A/c.	4.	Sales Accounts .... Dr.		10,000	
		Purchase Account .... Dr.		10,000	
		Rizwan Account			20,000
		Being credit purchase wrongly passed through sales book, now corrected.			
No effect of trial balance, no suspense A/c.	5.	Kamran Account .... Dr.		2000	
		Purchases Returns Account			2000
		(Goods returned, not entered in books now recorded)			
Caused discrepancy in trial balance, so suspense A/c is there	6.	Sales Account .... Dr.		36360	
		Suspense Account			36360
		Being wrong casting of sales book now, rectified.			

ILLUSTRATION NO. 5

How would you rectify the following errors.

(a) Monthly total of Rs. 180 of discount allowed column of the cash book was posted to the credit of discount received account.

(b) Rs. 5000 received in cash on account of sale of old Machinery were posted on the credit side of sales A/c.

(c) A customer's dishonored cheque of Rs. 2000 was debited to the Allowances account.

(d) Rs. 2000 received from X whose account had already been written off as bad debts, were credited to XY A/c.

(e) An amount of Rs. 3000 paid for erection of Machinery was wrongly debited to wages A/c.

(f) Salaries paid Rs. 4500 were entered as Rs. 5400.

Solution:

JOURNAL

	Date	Details	L/R	Dr. Amount	Cr. Amount
				Rs.	Rs.
Caused discrepancy of Rs. 360 in trial balance, so suspenses A/c is there.	(a)	Discount Allowed Account .... Dr.		180	
		Discount Received Account .... Dr.		180	
		Suspense account			360
		Being discount allowed posted wrongly now rectified.			
No effect on trial Balance	(b)	Sales Account .... Dr.		5000	
		Machinery Account			5000
		Being Machinery sold credited to sales A/c, now rectified.			

No effect on trial Balance	(c)	Customer's Account .... Dr. Allowances Account Being cheque dishonored debited to allowances A/c now rectified.		2000	2000
No effect on trial Balance	(d)	XY account .... Dr. Bad debts recovered Account ...... Being wrong credit to XY A/c, now rectified		2000	2000
Error of principle. No effect on trial balance.	(e)	Machinery Account .... Dr. Wages account Being wrong debit to wages A/c, now rectified.		3000	3000
No effect on trial balance	(f)	Cash Account .... Dr. Salaries Account Being wrong debit to salaries A/c and wrong credit to cash A/c, now rectified,		900	900

ILLUSTRATION NO. 6

An accountant while preparing the trial balance on 31st December, 1990 found that the credit total of the trial balance was short by Rs. 2282. The difference was placed to the Suspense A/c. The following errors were discovered afterwards:

- **(a) The sales book has been under-cast by Rs. 400**
- **(b) A cheque drawn for wages for Rs. 1020 was wrongly posted to wages A/c as Rs. 1002.**
- **(c) Furniture purchased for Rs. 1040 has been debited to purchases A/c as Rs.1640**
- **(d) Rs. 550 received from Rahim debited to his account.**
- **(e) Discount received Rs. 100 was posted to the wrong side of Discount A/c.**

Req : **Give journal entries to rectify these errors and prepare suspense A/c.**

JOURNAL

	Date	Details	L/R	Dr. Amount	Cr. Amount
				Rs.	Rs.
Credit column of trial balance short by Rs. 400	(a)	Suspense Account .... Dr. Sales Account (Being under casting of sales book, now rectified)		400	400
Debit column of trial balance short by Rs. 18.	(b)	Wages account .... Dr. Suspense account (Being wrong posting to wages A/c rectified)		18	18

Credit column of trial balance short by Rs. 600.	(c)	Furniture account .... Dr. Suspense Account .... Dr. Purchases Account (Being wrong debit to purchases A/c, now rectified).	1040 600	 1640
Credit column of trial balance by Rs. 1100.	(d)	Suspense Account .... Dr. Rahim Account (Being wrong posting to Rahim A/c rectified).	1100	 1100
Credit column of trial balance short by Rs. 200	(e)	Suspense account .... Dr. Discount account (Being wrong posting to discount A/c now rectified).	200	 200

Dr. **Suspense Account** **Cr.**

Date	References	J/F	Amount	Date	Reference	J/F	Amount
			Rs.				Rs.
	Sales A/c		400		Balance B/d		2282
	Purchase		600		difference in T. B.		
	Rahim A/c		1100		Wages A/c		18
	Discount A/c		200				
			2300				2300

NOTE: When suspense A/c balance is given in the question, it should be recorded first while preparing suspense A/c. If Debit balance is given, it should be recorded on the debit side of suspense A/c and if credit balance in given (as given in this illustration) it should be recorded on the credit side of suspense A/c. It may be noted that when all the errors are rectified and posted to suspense A/c, the suspense A/c shows nil balance (both sides are equal).

ILLUSTRATION NO. 7

In taking out a trial Balance the Accountant finds that the total of the credit side exceeds that of debit side by Rs. 2410. He places the difference to a Suspense A/c and subsequently detects the following mistakes;

(a) Stationery purchased for Rs. 890 but debited to stationery A/c as Rs.980.

(b) A sum of Rs. 650 received from Aslam was credited twice in his account.

(c) Wages Rs. 250 paid for installing a machine were debited to wages A/c as Rs. 520.

(d) A sale of Rs. 350 was entered in the purchase book as Rs. 530 but customer's account was correctly debited with Rs. 350.

(e) A sale of Rs. 1000 to Farid was credited to his account twice.

(f) Old furniture sold for Rs. 6000 was passed through sales book.

Req : **Pass the rectifying journal entries and close the suspense Account.**

Solution:

JOURNAL

	Date	Details	L/R	Amount	Amount
				Rs.	Rs.
Credit column of trial balance short by Rs. 90	(a)	Suspense Account .... Dr.		90	
		Stationery Account			90
		(Being wrong debit to stationery now rectified)			
Debit column of trial balance short by Rs. 650	(b)	Aslam account .... Dr.		650	
		Suspense account			650
		(Being Aslam A/c wrongly credited twice, now corrected).			
Credit column of trial balance short by Rs. 270.	(c)	Machinery account .... Dr.		250	
		Suspense Account .... Dr.		270	
		Wages Account			520
		(Being wages A/c wrongly debited, now rectified).			
Credit column of trial balance by Rs. 880.	(d)	Suspense Account .... Dr.		880	
		Sales Account			350
		Purchase Account			530
		(Being wrong debit to Purchase A/c rectified).			
Credit column of trial balance short by Rs. 3000	(e)	Faired account .... Dr.		3000	
		Suspense account			3000
		(Being Farid A/c wrongly credited twice, now rectified).			
No effect on trial Balance	(f)	Sales account .... Dr.		6000	
		Furniture account			6000
		(Being furniture sold wrongly credited to sales A/c now rectified.).			

Dr. **Suspense Account** **Cr.**

Date	References	Amount	Date	Reference	J/F	Amount
		Rs.				Rs.
	Bal. b/d difference in T.B.	2410	(b)	Aslam A/c		650
(a)	Stationery A/c	90	(e)	Farid A/c		3000
(c)	Wages A/c	270				
(d)	Sales A/c	350				
(d)	Purchase A/c	530				
		3650				3650

EFFECT OF ERRORS ON THE FINAL ACCOUNTS OR THE FINANCIAL STATEMENTS:

It has already been discussed that best efforts should be made to locate and rectify the errors before preparation of Final Accounts for the years. But in certain cases when an accountant fails to locate and rectify the errors, and he is in a hurry to prepare the Final Account of the business for filing the returns to Income tax Department for income tax or sales Tax purposes, he prepares the Final Accounts by placing the difference in the Trial Balance to suspense A/c. In the next accounting period. The errors are located and rectified and profit of the previous year is adjusted.

EFFECT OF ERRORS ON NET PROFIT:

It must be remembered that only those errors affect the profit of the business which are related to Trading and Profit and the Loss account. It means that only mistakes in "Expenses Accounts" and "Revenue Accounts" (Rent A/c, wages A/c, repairs A/c, electricity charges A/c, sales Returns A/c, Purchase Returns A/c, Stocks A/c etc.) will affect the net profit of the business. Errors in these accounts will either increase or decrease the existing profit.

How the mistakes or errors and their rectification affect the profit. The following points are helpful to understand it.

1. If any Expense A/c or Revenue A/c is wrongly debited, the profit will decrease and when it is rectified the profit will increase.

   Profit is understand

   For example : Rent A/c wrongly debited with Rs. 2000 instead of Rs. 200, it will decrease the profit by Rs. 1800 and when this error is rectified after the preparation of the final accounts, the profit will be increased by Rs. 1800. It means the profit shown by profit and loss A/c will be adjusted by adding Rs.1800.

2. *Profit is overstated*

   If any Expense A/c or Revenue A/c is wrongly credited, it will increase the profit and when the error is rectified, the profit will be adjusted by deducting the amount of error from the profit.

FOR EXAMPLE:

Sales A/c is wrongly credited with Rs. 10,000 instead of Rs. 9000, the profit will be more by Rs.1000 and when this error is rectified, Rs. 1000 will be deducted from the profit shown by the profit and loss A/c.

The following rules are given to understand the effect of errors on net profit.

(a) If by error :

Any Expense debited less -------- will overstate the profit.

Any Expense debited more ------ will understate the profit.

(b) If by error :

Any Revenue Credited more -------- will overstate the profit.

Any Revenue Credited less ------ will understate the profit.

(c) If by error :

Any Expense omitted to be recorded ------- will overstate the profit.

(d) If by error :

Any Revenue omitted to be recorded -------- will understate the profit.

1. On rectifying the errors, because of which profit has been overstated the amount of error should be deducted from the profit shown by Profit and Loss Account.
2. On rectifying the errors, because of which the profit has been understated, the amount of error should be added to the profit shown by profit and Loss Account.

EFFECT OF ERRORS ON BALANCE SHEET:

If the error is committed in Assets A/c, Liabilities A/c or Capital A/c it will have its impact on the Balance Sheet only, because all these items are shown in the Balance Sheet and the Balance Sheet is prepared after the Profit and Loss Account has been prepared. So if there is any error in Cash A/c, Furniture A/c, Machinery A/c, Debtors A/c Creditors A/c, Bank A/c, etc. it will affect only the Balance Sheet.

ILLUSTRATION NO. 8

Show the effect of the following errors on Profit and Loss Account (Income Statement) and Balance Sheet.

(a) Purchases book was under-cast by Rs. 2000

(b) Rs. 1400 paid for repairs to Machinery had been wrongly debited to Machinery A/c

(c) The total of discount column on the debit side of the cash book had been posted to the credit side of discount A/c as Rs. 400.

(d) Goods returned by a customer worth Rs. 3500 were taken into stock but not recorded in the books at all.

(e) Purchases returns book was overcast by Rs. 1000.

(f) Building purchased for Rs. 100,000 on credit but entry was passed for Rs.75000 only.

(g) Rs. 7000 received from Akram wrongly credited to the sales account.

Solution:

EFFECT OF ERRORS ON FINAL ACCOUNTS

Trading and Profit and Loss A/c or Income Statement		Balance Sheet
(a) Gross profit overstated by Rs. 2000		(a) Capital A/c overstated by Rs. 2000.
(b) Net profit overstated by Rs. 1400.		(b) Asset (Machinery A/c) overstated by Rs. 1400 and Capital also over cost by Rs. 1400.
(c) Net profit overstated by Rs. 800		(c) Capital A/c overstated by Rs. 800.
(d) Gross profit overstated by Rs. 3500		(d) Asset (debtors A/c or Account receivable) overstated by Rs. 3500
(e) Gross Profit overstated by Rs. 1000.		(e) Capital A/c Overstated by Rs. 1000.
(f) No effect.		(f) Building A/c understated by Rs. 25000 and creditors (Account payable) also understated by Rs. 25000
(g) Gross profit overstated by Rs. 7000, Net profit also overstated by Rs. 7000		(g) Capital A/c and debtor A/c (A/R) overstated by Rs. 7000

ILLUSTRATION NO. 9

The following errors were detected in the books of Faisal & Sons on 31st December, 1990. The difference in the Trial Balance has been transferred to a Suspense A/c. The Final Accounts had been prepared on the basis of incorrect figures and the net profit disclosed by the profit and Loss Account was Rs. 86400. Find out the correct net profit for the year and close the Suspense A/c.

(1) Sales returns book was under-cast by Rs. 2000.

(2) Rs. 400 paid for stationery were credited to stationery account.

(3) Wages paid for erection of Machinery debited to Wages account Rs. 1520

(4) Cash received from Qasim had been debited in the cash book Rs. 780, but not credited to Qasim A/c.

(5) Sales book was overcast by Rs. 1000.

Solution:

JOURNAL OF FAISAL & SONS

	Date	Details	L/F	Amount Rs. Dr.	Amount Rs. Cr.
Profit overstated by Rs. 2000	(a)	Sales Returns Account .... Dr.		2000	
		Suspense account			2000
		Being sales returns book under-cast, now rectified.			
Profit overstated by Rs. 800	(b)	Stationery Account .... Dr.		800	
		Suspense Account			800
		Being stationery A/c wrongly credited now rectified.			
Profit overstated by Rs. 1520	(c)	Machinery Account .... Dr.		1520	
		Wages Account			1520
		Being wages A/c wrongly debited, rectified.			
No effect on profit.	(d)	Suspense Account .... Dr.		780	
		Qasim Account			780
		Being Qasim A/c not credited rectified.			
Profit over stated by Rs. 1000	(e)	Sales Account .... Dr.		1000	
		Suspense Account			1000
		Being Overcastting of sales book, now rectified.			

SUSPENSE ACCOUNT

Rs. 3020 is suspense A/c balance which is not given to us.

			Rs.				Rs.
	Qasim A/c		780	Sales Return A/c			2000
	Difference in T. B.			Stationery A/c			800
	(Balancing figure)		3020	Sales A/c			1000
			3800				3800

EFFECT OF ERRORS ON PROFIT BEFORE RECTIFICATION

Transaction No.	Profit Overstated	Profit under stated
	Rs.	Rs.
(a)	2000	—
(b)	800	—
(c)	—	1520
(d)	—	—
(e)	1000	—
	3800	1520

Profit before Rectification		Rs. 86,400
Less: Profit overstated	Rs. 3800	
Add: Profit understated	Rs. 1520	Rs. 2280
Correct Profit		Rs. 84,120

TEST YOUR KNOWLEDGE

1. **Which of the following errors will cause the trial balance out of balance:**
   (a) Recording a transaction twice in a subsidiary book.
   (b) A debit to an incorrect expense account.
   (c) A credit to an expense account instead of credit to a revenue account.
   (d) Omission of posting discount allowed total of the cash book.
   (e) Posting a debit entry to the credit side of an account.
   (f) A credit to an asset account instead of a debit to a liability account.
   (g) Omission of posting from the purchases book to a creditor account.
   (h) Omission of recording a transaction in a subsidiary book.
   (i) Purchase of an asset entered in purchases book.

Ans: *[(a), (d), (e), (f), (g)]*

QUESTIONS

(1) What are the errors disclosed by the Trial Balance?
(2) What are the steps to be taken if the Trial Balance does not agree?
(3) What do you mean by one-sided errors and two-sided errors? How do you rectify them if they are detected after preparation of Trial Balance?
(4) What is a suspense Account? When is it made use of? What does balance of this account represent?

PROBLEMS

1. How would you rectify the following errors detected before preparing the Trial Balance.?
   (a) Sales returns Book has been under-cast by Rs. 500.
   (b) A Payment of Rs.4000 on account of rent has been posted twice to Rent A/c.
   (c) A sum of Rs.2000 received from Nasir has not been posted to his account.
   (d) A sum of Rs. 750 debited to Imran A/c as Rs. 75.
   (d) A sale of Rs. 3000 has been credited to customer's A/c.
2. Rectify the following errors, if they are detected after the preparation of the Trial Balance.
   (i) Sales to A Rs. 5000 credited to his account.
   (ii) Sales to A Rs. 5000 debited to his account as Rs. 500.
   (iii) Sales Book under-cast by Rs. 10,000.
   (iv) Purchases Book under-cast by Rs. 5000.
   (v) Sales Book overcast by Rs. 2000.
   (vi) Purchases Book overcast by Rs. 3000.
   (vii) Purchase from X Rs. 2300 credited to his account as Rs. 230.
   (viii) Purchases from X Rs. 2300 debited to his account.
3. Rectify the following errors.
   (a) Returns Inward Book has been under-cast by Rs. 800
   (b) Returns Outward Book has been under-cast by Rs. 1300
   (c) Returns Inward Book has been overcast by Rs. 400.
   (d) Returns Outward Book has been overcast by Rs. 900.
   (e) Rent paid Rs. 3000 debited to Landlord' personal account.
4. Give journal entries to rectify the following errors.
   (a) Machinery sold for Rs. 10,000 has been posted to Sales A/c.
   (b) Rs. 5000 withdrawn by the proprietor for his personal use have been debited to Trade Expenses A/c.
   (c) Cost of repairs Rs. 500 has been charged to Machinery account.
   (d) Rs. 3900 received from Saleem have been posted to Waseem A/c.
   (e) Furniture purchased for Rs. 8000. has been debited to purchase A/c.
   (f) Purchase of goods from Arshad & Co. Rs. 4000 was omitted to be recorded in the books.
   (g) Rs. 9500 paid to Nazir have been wrongly debited to Kabir A/c.
5. Write entries for the rectification of errors given below :
   (i) Legal expenses Rs. 3000 paid to lawyer have been wrongly debited to his personal account.
   (ii) A bill receivable for Rs. 2000 was passed through bills payable Book. The bill was given by X.
   (iii) Trade expenses of Rs. 180 posted in the ledger as Rs. 810.
   (iv) A sale of Rs. 3000 to A was wrongly debited to the account of B.
   (v) Sales book was overcast by Rs. 3000.
   (vi) Total of the sales book Rs.54540 was posted to the sales A/c as Rs.55440.

6. Rectify the following errors:
   (a) An amount of Rs. 900 paid for installation of machinery was debited to the wages A/c.
   (b) Salaries paid Rs. 950 were debited to the salaries A/c as Rs. 590.
   (c) Goods sold to XY for Rs. 9000 were debited to YZ A/c.
   (d) A bill of Rs. 2000 paid for owner's personal use was wrongly debited to Trade expenses A/c.
   (e) Rs. 300 received from A whose account had already been written off as bad debts were credited to his account.
   (f) Goods purchased for Rs. 4200 from Arif were recorded in the Sales Book.
7. Give journal entries to rectify the following errors.
   (a) A purchase of Rs. 10,000 from Akram was wrongly passed through the Sales Book.
   (b) A purchase of Rs. 7000 from Dawood was wrongly passed through the purchases Returns Book.
   (c) A purchase of Rs. 4800 from Sarwar was wrongly passed through the Sales Returns Book.
   (d) A sale of Rs. 8000 to Babar was wrongly passed through the Sales Returns Book.
   (e) A sale of Rs.12,000 to Hafeez was wrongly passed through the Purchases Book.
   (f) A sale of Rs. 6400 to Liaqat was wrongly passed through the Purchases Returns Book.
8. Rectify the following errors by passing necessary journal entries.
   (i) A sale of Rs. 496 to Ashraf was entered in the Sales Book as Rs. 694. Ashraf A/c was, however debited, with Rs. 964.
   (ii) A bill received from Salman & Co. for repairs done to furniture Rs. 200 and furniture purchased for Rs. 2000 was wrongly entered in the Purchases Book.
   (iii) An item of Rs. 4000 relating to prepaid rent was omitted to be brought forward.
   (iv) Received a final dividend of Rs. 400 from Anwar whose account had previously been written off as bad debts, was credited to his newly opened A/c.
   (v) An item of purchase of Rs. 1510 was entered in the Purchase Book at Rs. 150 and posted to the supplier's A/c as Rs. 510.
   (vi) A sales returns of Rs. 1000 were not passed through the sale returns book, though goods were duly taken into the stock.
9. Pass the necessary rectification journal entries to correct the following errors :
   (a) A bill for Rs. 10,000 for credit sales to Zahid has not been recorded in the Sales Book.
   (b) Goods purchased from Khalid Bros. for Rs. 15,000 have been entered in the purchases Book as Rs. 51,000.
   (c) An amount of Rs. 200 spent on the purchase of stationery has been debited to salaries A/c.
   (d) A sum of Rs. 5000 received from Asif was not entered in the Cash book.
   (e) The Sales Returns Book for December has been cast Rs. 5000 short.
   (f) While carrying forward the total of the Sales Book from page No. 14 to page No. 15, the amount was written as Rs. 1,57,786 instead of Rs.1,75,586.

10. The following errors were found from the Books of a firm. Pass the necessary entries to rectify them.

(a) A table purchased costing Rs. 650 had been passed through the Purchases Day Book.

(b) Rs. 8000 paid for wages to workmen for making show cases had been charged to the Wages A/c.

(c) A sale of Rs. 18000 has been passed through the purchases Book. The Customer's account has, however been correctly debited.

(d) A sale of Rs. 4500 to Kashif Bros. was credited to their account.

(e) Rs. 30,000 paid for the purchase of a Motor Cycle for a partner, had been charged to the Miscellaneous expenses account.

(f) A purchase of Rs. 696 had been debited to supplier's account as Rs. 632. The supplier was Sarwar.

11. The Trial Balance of a trader did not agree. The accountant transferred the difference to the suspense A/c and subsequently detected the following mistakes.

(i) Return of goods to a supplier, Saleem & Co. for Rs. 2000 has not been posted to their account.

(ii) Interest received Rs. 2400 though entered in cash book, was not posted to the concerned account.

(iii) Purchases returns to Mukhtar Rs. 3000 have been wrongly entered in the Sales Returns Book.

(iv) An amount of Rs. 3840 which was to be debited to Naeem account, wrongly debited as Rs. 3480.

(v) Furniture purchased for Rs. 7000 was posted on the debit side of the building account.

(vi) Wages paid Rs. 8000, posted to the wages A/c twice.

Reg: Give rectifying entries and prepare a suspense A/c.

12. Rectify the following errors :

(a) Rs. 840, a debit balance in Amjad account are written off as bad debts, but only Rs. 480 were entered instead of Rs. 840, in addition to it Anwar Account was credited instead of Amjad A/c.

(b) Rs. 2000 paid for college fees of proprietor's son were charged to the Trade expenses account.

(c) Bad debts recovered Rs. 500 from Arshad were credited to his account.

(d) A receipt of Rs. 3500 from Saeed & Co. was credited to their account as Rs. 5300.

(e) Sales returns of Rs. 500 were taken into stock but no entry was passed in the books.

13. A book-keeper failed to balance his Trial Balance. The credit side was exceeding the debit side by Rs. 1000. The difference was entered in a suspense A/c. Later the following errors were discovered. Pass the journal entries to rectify them and prepare the suspense account.

(a) The total of the credit side of Mohsin A/c was overcast by Rs. 1000.

(b) Sales Book was under-cast by Rs. 1000.

(c) Goods wroth Rs. 1000 were purchased from Nasir but were entered in the Sales Book. However, the account of Nasir was correctly credited.

(d) The total of purchases returns book Rs. 2000 was not posted to the ledger.

(e) A credit balance of Rs. 7550 of the Rent received Account was shown as Rs. 5700.

(f) Goods worth Rs. 6200 sold to Dawood, were correctly entered in the Sales Book, but posted to Dawood A/c as R. 2600.

(g) Goods amounting, to Rs. 750 were sold to Mahmood & Co. for cash. It was correctly recorded in the Cash Book,.but was wrongly posted to Mahmood & Co. account also.

14. In taking out a Trial Balance, a book keeper finds that he is out Rs. 800 excess debit. Being desirous of closing his books, he places the difference to a newly opened suspense account. In the next period, he discovers the following discrepancies,

(i) An item of sale for Rs. 5900 was posted to the Sales A/c as Rs. 9500.

(ii) The total of the Sales Returns Book has been added Rs. 100 short.

(iii) An amount of Rs. 3700 received from a customer has been credited to his account as Rs. 7300.

(iv) Rs. 1,50,000 paid for purchase of building have been charged to the ordinary purchase account.

(v) A sum of Rs. 9500 written off from building A/c as depreciation has not been posted to depreciation A/c.

(vi) An amount received from a debtor of Rs. 9700 has been debited to his account as Rs. 7900.

Req: Give the rectifying entries and prepare the suspense account. State also the ultimate effect of these correcting entries on the profit of the business.

15. A trader by preparing his Trial Balance found Rs. 780 excess debit and transferred it to the suspense account. Later he found the following errors.

(a) Commission account balance (Dr.) Rs. 2430 was not transferred to the Trial Balance.

(b) The total of the sales book Rs.3480 had not been posted to the sales A/c.

(c) Sale of old furniture for Rs. 2400 was entered in the Sales Book.

(d) Purchases made from Raja Stores for Rs. 2250 had-been forgotten to enter in the books.

(e) Cash paid to Rehman Rs. 3520 was posted to his account as Rs. 3250.

(f) Goods sold to A for Rs. 1250 posted in B's Account.

Req: (1) Pass the rectifying entries,

(2) Prepare suspense account.

(3) Ascertain correct profit after the rectification of errors-Before the rectification of errors the profit was Rs. 43870.

16. The Trial Balance of Rehman & Co. did not agree. The credit side was exceeding that of debit side by Rs. 10,000 and the difference was placed in Suspense A/c. The following errors were discovered later on. To rectify these errors pass necessary journal entries and prepare Suspense Account. State also the effect of errors on Final Accounts.

(a) Purchase Book was overcast by Rs. 1800.

(b) An amount of Rs. 2600 receivable from Salman & Co. was not included in Debtors schedule.

(c) Received Rs. 5800 from Khawaja & Co. but this was credited to their account as Rs. 5000.

(d) Goods sold to Ahsan for Rs. 7000 on credit were not posted to his account.

(e) Rafiq Bros. returned goods worth Rs. 3000. This was credited to their account but not entered in the Sales Returns Book.

17. The accountant found a difference of Rs. 721.50 in the Trial Balance and transferred it to the debit of Suspense Account. The following errors were discovered later. To rectify these errors make Journal entries and prepare suspense account.

(i) The total of Sales Returns Book Rs. 330.75 posted to the credit side of Purchases Account.

(ii) The credit side of Salman's Account was overcast by Rs. 180.

(iii) A bad debt of Rs. 75 in Raza's Account was not found on the debit side of bad debts account.

(iv) An amount of Rs. 1462.11 received from Kashif though correctly recorded in the Cash Book, was posted to his account as Rs. 1312.11.

(v) Sales Book was under cast by Rs. 45.

18. The Trial Balance of M. Nasim did not agree and the difference in books was carried to a suspense account. Correct the following errors which accounted for the difference. Also prepare the Suspense Account.

(a) A Cash Sale of Rs. 3750 to Rahat, correctly entered in the Cash Book, was also posted to the credit of his personal account.

(b) Goods returned by Moeen, Rs. 300 have been entered in the Returns Outwards Book. However, Moeen's account has been correctly posted.

(c) The Purchases Book has been under-added by Rs. 900, Rs. 600 and Rs. 1500 respectively on consecutive three pages.

(d) Purchase of Furniture on credit from Lahore Furniture's for Rs. 7500 was entered in the Purchases Book.

(e) The account of a debtor for Rs. 12000 had been written off as bad, but the entry had been made only in the personal account.

(f) The Sales Book was under cost by Rs. 50, Rs. 175 and Rs. 75 respectively on consecutive three pages.

19. Pass the Journal Entries to rectify the following errors:

(a) Monthly total of Rs. 270 of discount allowed column of Cash Book was posted to the credit of discount received account.

(b) An amount of Rs. 1500 was received in full settlement from a customer after he was allowed a discount of Rs. 250, but while writing the Cash Book, the amount received was entered in discount column and discount allowed was entered in the amount (Cash) column.

(c) A receipt of Rs. 1250 from Rana & Co. was recorded as Rs. 2150.

(d) Rs. 10000 being Purchases Returns were posted to the debit of Purchases Account.

(e) Discount of Rs. 200 received, entered in the Cash Book was not posted in the ledger.

(f) Rs. 754 paid for repairs to motor car, were debited to Motor Car Account as Rs. 574.

(g) A sale of Rs. 3500 to Mr. X was entered in the Sales Book as Rs. 5300.

(h) While carrying forward the total of one page in Saleem's Account the amount of Rs. 250 was written on the credit side instead of debit side.

(i) The Purchase of Machine on 1st April 1994 for Rs. 60,000 was entered in the Purchases Book. The firm write off depreciation @ 10 % p.a (assuming that accounting year ends on 31st December every year).

(j) The Sales Book for the month of April was overcast by Rs. 1000. It was also found that a sale of Rs. 4500 to Moon was entered in the Sales Book as Rs. 5400 from where he was debited by Rs. 5900.

CHAPTER - 16

ACCOUNTS FROM INCOMPLETE RECORDS

ACCOUNTS FROM NCOMPLETE RECORDS

We have now learned much about the double–entry system of record keeping both from the broad point of view and the narrow technical point of view as the means of providing a continuous record of business transactions. It has been shown that double entry does not mean, as is sometimes assumed, the recording of same thing twice. Double–entry is not double accounting but is rather a system of complete accounting as compared to Single–Entry accounting which, for the most part, is incomple accounting. In double–entry accounting the two sides of every transaction are recorded. In Single–Entry accounting some transactions may not be recorded at all while in others only one side of the transaction is recorded. This system of book–keeping is generally followed by small business concerns whose owners keep either no record of transactions at all, or incomplete records.

Single–Entry book–keeping system may vary from a mere listing of events in a form called a day book to the use of special journals and ledgers. Typically, however, this system consists of the following book–keeping records: (a) a day book or general journal, (b) a cash book, and (c) ledger accounts for individual customers and creditors. No other accounts and records are maintained with the result that expenses, reveneus and some assets accounts balances are not available. Thus it is not possible to arrive at a trial balance, and the financial statements are not easy to prepare.

Many small business concerns are being run successfully by relatively untrained people. One does not need higher education to succeed in business – a tough character and a capacity for hard work are more important. Establishing the right business in the right place is even more vital.

How does the self made man, who conducts his entire affairs without written records or incomplete records, face up to the problem of discovering the profitability of his business? Years ago he would not have bothered; he would judge it by the gradual increase in his assets which he possessed. Today the revenue collecting authorities of whatever country he lives it will require an annual assessment of his profit or income, so that they can decide the government's share of that income.

PROFIT DETERMINATION UNDER SINGLE–ENTRY SYSTEM:

(1) Profit determination by Increased Net–worth method.

(2) Profit determination by conversion method.

1. PROFIT DETERMINATION BY INCREASED NET–WORTH METHOD:

The businessman who does not keep written records can see, as the years go by, a gradual increase in the assets of his business. An airline operating in Pakistan began forty seven years ago with two aircraft, and now has a capital (Net worth) of Rs. 100 billions. Where did this increased wealth come from? It was

accumulated over the years by the profitable activities of the sole pilot who founded it. He did not withdraw all the profits he earned, but he clearly must have lived on these profits by drawing some of them. The rest were retained in the business–for buying new aircraft and premises, building booking offices, and so on.

Profit can therefore be measured as an increase in the **Net worth** of a business. Let us see an example given below.

Ashraf Trader sets up a business on 1st January, 1993 as a hawker. He has a van, valued Rs. 180,000, weighing machines and other equipments worth Rs. 48,000, and he buys stock valued at Rs. 80,000. He keeps no records, but on 31st Dec. 1993 he has two vans, valued Rs. 365000 and Rs. 120,000, scales and other equipments worth Rs. 85000 and stock valued at Rs. 300000. He has Rs. 235000 in the bank, and a cash balance of Rs. 20,000. He owes Mr. Nazir Rs. 32000 for goods supplied in the last month. He has during the year given his wife housekeeping money of Rs. 7000 per week and has used Rs. 3000 per week for personal expenses. During the year his father left him a legacy of Rs. 200000 which he put into the business. How do we calculate the profits of the business?

First of all we have to find out the net worth (capital) of the business both at the beginning of the year and at the end of the year to see whether there has been an increase in the net worth. To do this we need to prepare a **Statement of Affairs** for each of the days mentioned. Statement of Affairs is a sort of Balance Sheet having assets on left side and liabilities and net worth on the right side. Given below is the statement of Affairs at the beginning of the year:

ASHRAF TRADERS

Statement of Affairs

as at 1st Jan. 1993

Assets	Rs.	Liabilities & Capital	Rs.
Stock	80,000	Liabilities	NIL
Equipment	48000	Capital at the start:	308,000
Motor Vehicle	180,000	(Balancing figure)	
	308000		308000

From the above Statement of Affairs it is clear that on 1st Jan. 1993 the net worth (capital) of the business to Ashraf Trader was Rs. 308000.

The second Statement of Affairs as on 31st Dec., 1993 is as follows:

ASHRAF TRADERS
Statement of Affairs
as at 31st Dec., 1993

Assets	Rs.	Liabilities & Capital	Rs.
Cash in hand	20000	Creditors	32000
Cash at Bank	235000	Capital at the end	1093000
Stock	300000	(Being figure)	
Equipment	85000		
Motor Vehicles	485000		
	1125000		1125000

It is clear from the two statements of affairs that the net worth (capital) of Ashraf Trader's business to him has increased from Rs. 308000 to Rs. 1093000. This increase in net worh has come partly from the profits made during the year and partly from the fresh capital introduced by him (legacy left to him by his father). He has more assets now than he had before, for these two reasons.

CALCULATION OF PROFIT UNDER THIS METHOD:

(a) Calculate the increase in capital by preparing two statements of affairs as shown above, and subtracting the opening capital from the closing capital. In our example:

Closing capital — Opening Capital= Insurance in capital

Rs. 1093000 — Rs. 308000 = Rs. 785000

(b) Adjust this figure (785000) by taking into account drawings. Mr. Ashraf gave his wife Rs. 7000 per week and also drew Rs. 3000 per week himself.

Total Drawings = Rs. 7000 + 3000 = 10,000 × 52

= Rs. 520000

If Mr. Ashraf had not withdrawn this money from the business it would still have been in the business, so that the increase in net worth (capital) would have been more than it was. So,

True increase in capital = 785000 + 520000

= Rs. 1305000

(c) Adjust this figure for any increases or decreases in capital that can be explained by something other than profits.

In our example a ledgacy (fresh capital) of Rs. 200,000 explains some of the increase in the capital. This Rs. 200000 did not come from profits but from a source outside the business (not because of business activities). Therefore we have:

Profit for the year = True increase in Capital – Legacy

= 1305000 – 200,000 = Rs. 1105000.

This is the profit earned by Ashraf Traders on which he should pay tax.

ADJUSTMENTS WITH THE INCREASED NET–WORTH METHOD:

Just as in all other Final Accounts there may be some which must be considered while finding out the profit under this system. Before preparing the two statements of affairs we would question the proprietor on the valuations he is placing on his assets. For instance, if the motor vehicle was valued at the end of the year at the same value as at the beginning, we would point out that it must have depreciated. The adjustments should be taken into account directly, by reducing the value of the relevant asset on the statements of affairs. This particularly affects the asset, Motor Vehicle, since it will be necessary to ensure that the proprietor is not including depreciation he knows to be accounted for. We would also point out to him that he should take into account some amount of depreciation on Motor Vehicle due to its usage.

In summary, profit under this system can be ascertained in the following way:

Adjusted Capital (at the end) = Capital as per statement of affairs at the end + Drawings & Interest on drawings – Fresh capital introduced

Now adjusted capital at the end should be compared with the capital at the beginning of the year. In case former exceeds the latter the difference is profit otherwise it is loss.

$$\left\{ \begin{array}{c}\text{Adjusted capital}\\ \text{(at the end)}\end{array} - \begin{array}{c}\text{Capital at the}\\ \text{start as per}\\ \text{statement of}\\ \text{affairs at the}\\ \text{start}\end{array} = \begin{array}{c}+\text{ Profit}\\ -\text{ Loss}\end{array} \right\}$$

The above mentioned method can be expressed in vertical form shown as under:

STATEMENT OF PROFIT OR LOSS
for the year ending ....

		Rs.
Capital or Net–worth as at the end		x x x
Add:	Drawings made during the year	x x x
		x x x
Loss:	Additional Capital introduced during the year	x x x
	Adjusted capital at the end	x x x
Less:	Capital at the beginning of the year ...	x x x
	Profit made during the year	x x x

ILLUSTRATION NO. 1

The following statements of affairs have been drawn up to give the financial positions as on January 1, 1994 and 31st Dec., 1994, respectively, of Mr. Farooq, who keeps his books on a single entry basis.

STATEMENT OF AFFAIRS

as at 1st Jan., 1994

Assets	Rs.	Liabilities & Capital	Rs.
Cash	127750	Creditors	265500
Debtors	877750	Capital at the start	
Stock	1260000	(Balancing Fig.)	2235000
Fixtures	235000		
	2500500		2500500

STATEMENT OF AFFAIRS

as at 31st Dec., 1994

Assets	Rs.	Liabilities & Capital	Rs.
Cash in hand	160000	Creditors	339050
Cash at Bank	425000	Wages due	12450
Debtors	1150000	Capital at the end	3003500
Stock	1400000	(Balancing Fig.)	
Fixtures	220000		
	3355000		3355000

Farooq has transferred Rs. 60000 a month from his business bank account to his private bank account by way of drawings, and has taken Rs. 12500 of stock for his private use.

Calculate Mr. Ashraf's profit for the year.

Solution:

MR. ASHRAF
Statement of Profit & Loss
for the year Ending 31st Dec., 1994

	Rs.
Capital at the end of 1994	3003500
Add: Drawings for the year	72500
Adjusted capital at the end	3076000
Less: Capital at the beginning of the year	2235000
Profit made during the year	841000

DISADVANTAGES OF SINGLE ENTRY SYSTEM:

1. It is not possible to obtain accurate information regarding the results of business operations. Because, under single entry system, nominal accounts relating to losses, expenses, gains and incomes have not been maintained. In the absence of these accounts necessary classified information required for preparing profit and loss account is not available. Hence profit and loss account cannot be prepared.
2. Information relating to assets and liabilities cannot be reliable because respective accounts have not been maintained. Thus even balance sheet can't be prepared. Consequently true financial position of the business can't be ascertained.
3. Because both the aspects of each transaction have not be recorded therefore even trial balance can't be extracted and thus arithmetical accuracy of the books can't be checked.
4. Completeness of the system under double entry provides certain checks which are missing in the single entry. Committing of frauis ds easier and detection difficult.
5. Due to the lack of detailed and classified information the owner is bound to experience difficulties in situations like:-

When business is desired to be sold–in ascertaining its value:

When goodwill is desired to be sold–in ascertaining its value;

When income–tax authorities have assessed at higher income – in convincing the authorities regarding the reliability of his income determination;

When stock has been destroyed by fire etc. – in filing claim with insurance company;

When it is desired to arrange loans for financing the business – in convincing the creditor regarding the profitability and liquidity of his business.

ILLUSTRATION NO. 2

X, who keeps his books on single entry tells you that his capital on 31st December 1995 is Rs. 56100 and his capital on 1st January 1995 was Rs. 57600. He further informs you that during the year he withdrew for his household purposes Rs. 25260. He once sold his investments of Rs. 6000 at 2 % premium and brought that money into business.

You are required to prepare a statement of profit or loss.

Solution:

MR. X
STATEMENT OF PROFIT
for the year ended 31st December 1995

		Rs.
	Capital as on 31st December 1995	56100
Add:	drawings made during the year	25260
		81360
Less:	additional capital introduced during the year (Sale of Rs. 6000 investments at 2 % premium)	6120
	Adjusted capital as on 31st December 1995	75240
Less:	Capital on 1st January 1995	57600
	Profit made during the year	17640

ILLUSTRATION NO. 3

Mr. Nasir kept his books on single entry system. His position on 31st December, 1990 was as follows:

Cash in hand Rs. 400, cash in bank Rs. 6000, stock Rs. 40000, sundry debtors Rs. 17000, fixture and fitting Rs. 3600, plant and machinery Rs. 30,000, sundry creditors Rs. 44000.

Mr. Nasir put Rs. 10000 during the year as new capital and his drawings were @ Rs. 1500 per month.

His position on 31st December 1991 was as follows:-

Cash in hand Rs. 600, cash in bank Rs. 4000, sundry debtors Rs. 28000, stock Rs. 38000, plant and machinery Rs. 54000, fixtures and fittings Rs. 3000, sundry creditors Rs. 58000.

From the above information, prepare a statement of affairs showing profit or loss during the year ending on 31st December 1991.

Solution:

MR. NASIR
STATEMENT OF AFFAIRS
as on 31st December, 1990

Assets	Rs.	Liabilities & Capital	Rs.
Cash in hand	400	Sundry creditors	44000
Cash at bank	6000	Capital on 31.12.1990	
Stock	40000	(Being the excess of assets	
Sundry debtors	17000	over liabilities)	53000
Fixtures and fittings	3600		
Plant and machinery	30000		
	97000		97000

MR. NASIR
STATEMENT OF AFFAIRS
as on 31st December, 1991

Assets	Rs.	Liabilities & Capital	Rs.
Cash in hand	600	Sundry creditors	58000
Cash at bank	4000	Capital on 31.12.1991	
Sundry debtors	28000	(Being the excess of assets	
Stock	38000	over liabilities)	69600
Fixture and fittings	3000		
Plant and machinery	54000		
	127600		127600

Profit & Loss Statement:

	Rs.
Capital as on 31st December 1991	69600
Add drawings made during the year	18000
	87600
Less additional capital introduced during the year	10,000
Adjusted capital on 31st December 1991	77600
Less Capital on 31st December 1990	53000
Profit made during the year	24600

ILLUSTRATION NO. 4

M. Kashif keeps his books under Single Entry system. His position on 31st March, 1993 was as follows:

Cash in hand Rs. 2400; Cash at Bank Rs. 25500; Debtors Rs. 18400; Stock Rs. 28600; Furniture Rs. 5000; Creditors for goods supplied Rs. 18700; Outstanding Wages Rs. 2000.

On 1st October, 1993, Kashif introduced Rs. 10,000 as further capital in the business and withdrew on the same date Rs. 7000 out of which he spent Rs. 5000 on the purchase of a machine for the business.

On 31st March, 1994 his financial position was as follows:

Cash in hand Rs. 2100; Cash at Bank Rs. 27500; Stock Rs. 31500; Debtors Rs. 24200; Furniture Rs. 6000; Creditors Rs. 25200; Prepaid Insurance Rs. 200.

From the above mentioned information prepare the necessary statements showing the profit or loss for the year ending 31st March, 1994 after taking into account the following adjustments;

(a) Depreciate Furniture and Machine @ 10 % p.a.

(b) Write off bad debts Rs. 1200 and provide 5 % for doubtful debts.

(c) Goods taken by M. Kashif for personal use Rs. 1500.

(d) Provide interest on capital @ 10 % p.a.

Solution:

M. KASHIF
STATEMENT OF AFFAIRS
As on 31st March, 1993

Assets	Rs.	Liabilities & Capital	Rs.
Cash in hand	2400	Creditors	18700
Cash at Bank	25500	Outstanding Wages	2000
Debtors	18400	Capital (Balancing Fig.)	59200
Stock	28600		
Furniture	5000		
	79900		79900

M. KASHIF
STATEMENT OF AFFAIRS
As on 31st March, 1994

Assets		Rs.	Liabilities & Capital	Rs.
Cash in hand		2100	Creditors	25200
Cash at Bank		27500	Capital (Bal. Fig.)	68150
Stock		31500		
Debtors	24200			
Less: Bad debts	1200			
	23000			
Less: Provision for B.D.	1150	21850		
Furniture	6000			
Less: Depreciation 10 %				
on Rs. 5000 = 500				
on Rs. 1000 = 50	550	5450		
$\left(\text{for } \frac{1}{2} \text{ year}\right)$				
Machinery	5000			
Less: 10 % depreciation				
for $\frac{1}{2}$ year	250	4750		
Prepaid Insurance		200		
		93350		93350

M. KASHIF
STATEMENT OF PROFIT OR LOSS
For the Year Ending 31st March, 1994

		Rs.
Capital as at 31st March, 1994		68150
Add: Drawings (cash Rs. 2000 + Goods Rs. 1500)		3500
		71650
Less: Additional capital introduced		10,000
Adjusted capital at the end of year		61650
Less: Capital as at 31st March, 1993		59200
Profit for the year before charging ~~interest~~ on Cap.		2450
Less: Interest on capital @ 10 % p.a.		
on Rs. 59200 for one year:	5920	
on Rs. 10,000 for half year:	500	6420
{Loss for the year}		3970

NOTE:

Date of purchase of furniture is not mentioned, so depreciation on this furniture (Rs. 1000) is charged for half year.

ILLUSTRATION NO. 5

The following are the assets and liabilities of Mr. Ahsan at the end and beginning of the year 1994:

	As at 31st Dec. 1994 Rs.	As at Jan. 1, 1994 Rs.
Land & buildings 1	**29400** 1	1 **30,000**
Plant & machinery 2	**60,000** 2	2 **48000**
Furniture & fixtures 3	**8100** 3	3 **8000**
Stock in trade 4	**28000** 4	4 **15000**
Sundry debtors 5	**155000** 5	5 **140,000**
Sundry creditors 6	**75000** 6	6 **72500**
Loan from bank 7	**50,000** 7	7 **60,000**
Other outstanding liabilities 8	**40,000** 8	8 **45000**
Cash at bank 9	**16000** 9	9 **18000**

During the year Mr. Ahsan had withdrawn Rs. 3000 in cash and Rs. 1500 in goods from the business. He had also introduced Rs. 50,000 as additional capital. A machine book value Rs.12500 had been sold during the year for Rs. 15000 and a new machine costing Rs. 29000 was purchased in replacement. New furniture costing Rs. 1000 was purchased during the year.

Prepare a statement of profit and loss for the year ended Dec. 31, 1994.

Solution:

MR. AHSAN
STATEMENT OF AFFAIRS
as on 1st January 1994

Assets	Rs.	Liabilities	Rs.
Land and building	30000	Sundry creditors	72500
Plant and machinery	48000	Loan	60000
Furniture and fixture	8000	Outstanding liability for expenses	45000
Stock	15000	Capital being the excess of assets	
Sundry debtors	140000	over liabilities	81500
Cash	18000		
	259000		259000

MR. AHSAN
STATEMENT OF AFFAIRS
as on 31st December, 1994

Assets		Rs.	Liabilities	Rs.
Land and building	30,000		Sundry creditors	75000
Less Depreciation	600	29400	Loan from bank	50,000
Plant and machinery	48000		Outstanding liabilities for	
Less Sale of plant	12500		expenses	40,000
	35500		Capital – being the excess of	
Add Purchases	29000		assets over liabilities	131500
	64500			
Less Depreciation	4500	60,000		
Furniture and fixture	8000			
Add Purchases	1000			
	9000			
Less depreciation	900	8100		
Stock in trade		28000		
Sundry debtors		155000		
Cash		16000		
		296500		296500

STATEMENT OF PROFIT OR LOSS

		Rs.
Capital as on 31st December 1994		131500
Add Drawings:		
Cash	3000	
Goods	1500	4500
		136000
Less gain on sale of machinery		2500
		133500
Less additional capital introduced during the year		50000
Adjusted capital as on 31st December 1994		83500
Less Capital on 1st January 1994		81500
Net profit made during the year		2000

CALCULATION OF PROFIT UNDER PARTNERSHIP:

When the accounts of a partnership are maintained under the single entry system, the calculation of profit or loss is made along the lines indicated above. The statement of affairs of partnership firms are prepared to ascertain the amount of the combined capitals of the partners at the beginning and at the end of the period. A statement of profit or loss is prepared to ascertain the gross profit during the period. Gross profit is ascertained by comparing combined capitals of the partners at the commencement and at the end of the period, after taking into account drawings made by the partners during the year and additional capital introduced.

The Gross profit is then placed on the credit of profit and loss adjustment account. It is adjusted for interest on partners capitals, interest on partners drawings, partners salaries etc. The net profit is distributed among the partners in the profit sharing ratio.

ILLUSTRATION NO. 6

A and B carried on business in partnership and sharing profits or losses in the proportion of 2 : 1, had the following balances to the credit of their accounts in the books of the firm as at 31st December 1995:

A	**Rs. 34,500**
B	**Rs. 18,000**

A statement of affairs prepared on 31st December 1996 discloses the following position of the business:

Assets	Rs.	Liabilities		Rs.
Cash on hand	6,750	Sundry creditors		
Cash at bank	4,500	for goods	19,500	
Sundry debtors	25,500	for expenses	3,900	23,400
Stock	33,000			
Furniture	4,200			
	73,950			23,400

During the year A had drawn Rs. 9,900 from the firm. He had also taken for his personal use goods worth Rs. 1,200. He had sold some goods of the business for Rs. 2,700 and retained their proceeds himself. He had personally paid to some of the employees of the firm Rs. 4,950 towards the salaries, which he was entitled to be reimbursed.

B had withdrawn Rs. 3,750 in cash and had also taken for his personal use goods worth Rs. 750. He had paid towards some expenses of the firm Rs. 2,400 from his private estate.

Prepare a statement showing the profit of the firm for the year ended 31st December 1996, as well as the balance sheet of the firm as on that date.

Solution:

	Rs.
Total assets on 31st December 1996	73,950
Liabilities on 31st December, 1996	23,400
Capital of A and B on 31st December, 1996	50,550

STATEMENT OF PROFIT

			Rs.
Combined capitals of A and B on 31st December, 1996			50,550
Add Drawings A			
Cash	9,900		
Goods	1,200		
Sales proceeds of goods retained	2,700	13,800	
Drawings B			
Cash	3,750		
Goods	750	4,500	18,300
			68,850
Less additions to capital			
A – Salaries of employees		4,950	
B – Expenses of firm		2,400	7,350
Adjusted capital of A and B on 31st December 1996			61,500
Less Capital of A and B in the beginning			52,500
Net profit for the year			9,000

A's share of profit: $\frac{2}{3} \times 9{,}000 = 6{,}000$

B's share of profit: $\frac{1}{3} \times 9{,}000 = 3{,}000$

BALANCE SHEET OF A & B
as on 31st December, 1996

Assets	Rs.	Liabilities & Capital		Rs.
Cash in hand	6,750	Sundry creditors for goods		19,500
Cash at bank	4,500	Sundry creditors for expenses		3,900
Sundry debtors	25,500	Capital accounts		
Stock	33,000	A's capital on 1.1.1996	34,500	
Furniture	4,200	Add additions	4,950	
		Add Net profit	6,000	
			45,450	
		Less Drawings	13,800	31650
		B's capital on 1.1.1996	18,000	
		Add additions	2,400	
		Add Net profit	3,000	
			23,400	
		Less Drawings	4,500	18,500
	73,950			73,950

CONVERSION METHOD:

Cases where, though, books maintained on single entry principle but subsidiary books like purchases book, sales books, returns books etc., also form part of the accounting records and it is possible to prepare trading and profit and loss account. To convert such a set of books into double entry the following procedure should be adopted:

1. Prepare statement of affairs as at the beginning of the period. All the items appearing in the statement of affairs (except debtors, creditors, cash and bank which are already in the relevant ledger) must be debited or credited to the relevant account in the ledger.

2. If the subsidiary books have been maintained then posting to the personal accounts must have already been done. Now the periodical totals should be posted to the appropriate impersonal accounts.

For example, total of purchases book and returns inwards book be debited to the purchases account and returns inwards account respectively. Similarly total of sales book and returns outwards book should be credited to the sale and returns outwards account respectively. From cash book posting to the personal

accounts must have already been done. Now do the posting relating to impersonal accounts viz. purchases (cash purchases) sales (cash sales) assets (purchase and sale of fixed assets) individual expenditure heads (salaries, wages, rent, insurance etc.) individual income heads (interest, commission, dividend etc.). This will complete the double entry of these books.

Examine carefuly personal accounts so as to find out if any amount has been posted directly therein without being recorded in any of the subsidiary books. Prepare a list of such transactions and pass journal entry and post it to the relevant account. Double entry being complete it should be possible to test the arithmetical accuracy of the books maintained by preparing a trial balance.

3. If subsidiary books have not been maintained then an analysis of sales and purchases ledger should be undertaken.

   (a) Analysis of sales or debtors' ledger will provide the information relating to; amount due by the debtors in the beginning (opening balance), credit sales during the year; bills receivable dishonoured (if any), cash received from them during the year; discount and other concessions allowed to them; bills receivable received; returns inwards; bad debts written off and transfers. Pass journal entries by debiting or crediting the respective impersonal accounts contra credit or debit being given to total debtor's account.

   (b) Analysis of purchases or creditor's ledger will provide information relating to; amount due to the creditors in the beginning (opening balance); credit purchases during the year; bills payable dishonoured (if any); cash paid to the creditors during the year; discount availed during the year; bills payable accepted; returns outwards and transfers. Pass journal entries by debiting or crediting the respective impersonal accounts contra credit or debit being given to total creditors, account. Double entry of all the transactions being complete prepare trial balance.

4. Make necessary adjustments for:- outstanding and prepaid expenses; income accrued due and income received in advance and provide necessary depreciation on fixed assets. Now trading and profit and loss account and balance sheet can be prepared in the usual way.

CALCULATION OF MISSING FIGURES:

1. OPENING STOCK:

The figure of opening stock if not given can be ascertained by applying gross profit percentage to sales. Prepare memorandum trading account, fill up the information given, calculate gross profit on sales by applying ratio of gross proit, to sales the balancing figure is opening stock.

2. CREDIT SALES AND CREDIT PURCHASES:

These can be ascertained by preparing total debtors' account and total creditors' account respectively. Proforma of these accounts is as below:

TOTAL DEBTORS' ACCOUNT

	Rs.		Rs.
Balance b/d	x x x	Cash	x x x
B/R (dishonoured)	x x x	Bank	x x x
Cash (paid for returns etc.)	x x x	B/R	x x x
Sales (credit)	x x x	Returns (inwards)	x x x
		Allowances	x x x
		Bad debts	x x x
		Balance c/d	x x x

TOTAL CREDITORS' ACCOUNT

	Rs.		Rs.
Cash	x x x	Balance b/d	x x x
Bank	x x x	Cash (for returns etc.)	x x x
Discount	x x x	B/P (dishonoured)	x x x
B/P	x x x	Purchases (credit)	x x x
Returns (outwards)	x x x		
Allowances	x x x		
Balance c/d	x x x		

3. DEBTORS AND CREDITORS:

If credit sales and credit purchases are given then opening or closing balances of debtors or creditors can similarly be found out by preparing total debtors and total creditors accounts.

4. BILLS RECEIVABLE AND PAYABLE:

Sometimes in the question bills receivable accepted by the customers during the year and bills payable accepted by the business (drawn by creditors upon us) during the year are not given. So before total debtors and total creditors accounts can be prepared it will be required to calculate the above by preparing bills receivable and bills payable account.

BILLS RECEIVABLE ACCOUNT

Balance b/d	x x x	Cash	x x x
Sundry debtors	x x x	S. debtors (B/R dishonoured)	x x x
		Balance c/d	x x x

BILLS PAYABLE ACCOUNT

Cash	x x x	Balance b/d	x x x
S. Creditors (B/P dishonoured)	x x x	S. Creditors	x x x
Balance c/d	x x x		

5. Memorandum trading account should be prepared in these cases where even the record of cash transactions is not dependable. Trading account in equation form may be expressed as follows:

Opening stock and purchases + direct expenses + gross profit = sales + closing stock. Now by preparing trading account relating to previous two or three years it is possible to calculate either rate of gross profit to sales or rate of gross profit to cost of goods sold. Any one of these rates (depending upon the information supplied) should be applied to the figures of the current year. (For example, if closing stock is missing then calculate gross profit by applying rate of gross profit to sales and if sales are missing then calculate gross profit by applying rate of gross profit to cost of goods sold), gross profit calculated and inserted in the memorandum trading account, now any one missing figures can be ascertained by balancing this account.

6. **EXPENSES AND REVENUES:**

Prepare each expense/revenue account concerned with the help of opening and closing balances and cash payments/cash receipts. Adjust for outstanding or accrued in the beginning and as at the end.

7. **BALANCE SHEET ITEMS:**

Balancing of an account provide us the mechanism by which we can find out only one figure from one account. Similarly statement of affairs when totalled is capable of providing information regarding any one missing figure. This may be opening capital or any one asset or any one liability.

ILLUSTRATION NO. 7

From the following facts supplied by A who keeps his books on the single entry, you are required to calculate 'total purchases'.

	Rs.
Opening balance of bills payable	**5,000**
Opening balance of creditors	**6,000**
Closing balance of bills payable	**7,000**
Closing balance of creditors	**4,000**
Bills payable discharged during the year	**8,900**
Cash paid to creditors during the year	**30,200**
Returns outwards	**1,200**
Cash purchases	**25,800**

Solution:

BILLS PAYABLE ACCOUNT

Dr.	Rs.		Cr. Rs.
Cash	8,900	Opening balance	5,000
Closing balance	7,000	Creditors–bills payable accepted during the year	10,900
	15,900		15,900

TOTAL CREDITORS ACCOUNT

Dr.	Rs.		Cr. Rs.
Cash	30,200	Opening balance	6,000
Bills payable a/c	10,900	Purchases	
Returns outwards	1,200	(Balancing figure)	40,300
Closing balance	4,000		
	46,300		46,300

Cash purchases	Rs. 25,800
Credit Purchases	40,300
Total purchases	66,100

ILLUSTRATION NO. 8

From the following facts supplied by Mr. X who keeps his books on the single entry, you are required to calculate 'total sales'.

Opening balance of bills receivable	**25,000**
Opening balance of sundry debtors	**39,000**
Closing balance of bills receivable	**35,000**
Closing balance of sundry debtors	**25,400**
Bills receivable encashed during the year	**1,00,000**
Cash received from debtors during the year (including Rs. 3,000 being the sales proceeds of an old typewriter sold on credit received during the year)	**2,90,000**
Returns inwards	**5,600**
Bad debts written off	**7,000**
Bills receivable dishonoured	**5,000**
Cash sales	**70,000**

Solution:

Dr. **BILLS RECEIVABLE ACCOUNT** Cr.

	Rs.		Rs.
Opening balance	25,000	Cash	1,00,000
Sundry debtors – bills receivable received during the year (balancing figure)	1,15,000	Debtors (Bills receivable dishonoured)	5,000
		Closing balance	35,000
	1,40,000		1,40,000

TOTAL DEBTORS ACCOUNT

	Rs.		Rs.
Opening balance	39,000	Cash	2,87,000
Bills receivable-dishonoured	5,000	Returns inwards	5,600
Credit sales (balancing figure)	3,96,000	Bad debts	7,000
		Bills receivable	1,15,000
		Closing balance	25,400
	4,40,000		4,40,000

Total Sales:	
Credit sales	3,96,000
Cash sales	70,000
Total sales	Rs. 4,66,000

NOTE:

Rs. 3,000 being the sale proceeds of an old typewriter sold on credit and received during the year will be deducted from the total cash received to ascertain the figure of credit sales.

ILLUSTRATION NO. 9

Jamil does not maintain proper books of account. From the following particulars prepare trading and profit and loss account for the year ended 31st December, 1992 and the balance sheet as on that date.

	31.12.1991	31.12.1992
Debtors	**9,000**	**12,500**
Stock 4,900	**6,600**	
Furniture	**500**	**750**
Creditors	**3,000**	**2,250**

Analysis of the other transactions is as follows:

	Rs.
Cash collected from debtors	30,400
Cash paid to creditors	22,000
Salaries	6,000
Rent 750	
Office expenses	900
Drawings	1,500
Additional capital introduced	1,000
Cash sales	750
Cash purchases	2,500
Discount received	350
Discount allowed	150
Returns inwards	500
Returns outwards	400
Bad debts	100

He has Rs. 2,500 as cash balance at the beginning of the year.

Solution:

WORKINGS:

Dr. **TOTAL DEBTORS ACCOUNT** Cr.

	Rs.		Rs.
Balance b/d	9,000	Cash	30,400
Credit sales	34,650	Returns inwards	500
(balancing figure)		Discount allowed	150
		Bad debts	100
		Balance c/d	12,500
	43,650		43,650

TOTAL CREDITORS ACCOUNT

	Rs.		Rs.
Cash	22,000	Balance b/d	3,000
Discount received	350	Credit purchases	22,000
Returns outwards	400	(balancing figure)	
Balance c/d	2,250		
	25,000		25,000

BALANCE SHEET

as on 31sf December 1991

Assets	Rs.	Liabilities	Rs.
Cash	2,500	Creditors	3,000
Debtors	9,000	Capital (balancing figure)	13,900
Stock	4,900		
Furniture	500		
	16,900		16,900

CASH ACCOUNT

	Rs.		Rs.
Balance b/d	2,500	Creditors	22,000
Debtors	30,400	Salaries	6,000
Capital	1,000	Rent	750
Cash sales	750	Office expenses	900
		Drawings	1,500
		Purchases	2,500
		Furniture	250
		Balance c/d	750
	34,650		34,650

TRADING AND PROFIT AND LOSS ACCOUNT

for the year ended 31st December, 1992

		Rs.			Rs.
Opening stock		4,900	Sales:		
Purchases:			Cash	750	
Cash	2,500		Credit	34,650	
Credit	22,000			35,400	
	24,500		Less Returns inwards	500	34,900
Less Returns outwards	400	24100	Closing stock		6,600
Gross Profit		12,500			
		41,500			41,500

Salaries	6,000	Gross profit	12,500
Rent	750	Discount received	350
Office expenses	900		
Discount allowed	150		
Bad debts	100		
Net Profit	4,950		
	12,850		12,850

BALANCE SHEET
as at 31st December, 1992

Assets	Rs.	Liabilities		Rs.
Cash	750	Creditors		2,250
Debtors	12,500	Capital		
Stock	6,600	Balance as at 1st		
Furniture	750	Jan. 1992	13,900	
		Add Fresh capital	1,000	
		Add Net profit	4,950	
			19,850	
		Less Drawings	1,500	18,350
	20,600			20,600

ILLUSTRATION NO. 10

Mohammad Shafiq carries on a small business, but he does not maintain a complete set of account books. He banks all receipts and makes all payments only by means of cheques. He maintains properly a cash book, a sales ledger and a purchase ledger. He also makes a proper record of the assets and liabilities as at the close of every accounting year. From such records you are able to gather the following facts.

Receipts for the year ended 31.12.1992:	**Rs.**
From sundry debtors	**17,625**
Cash sales	**4,125**
Paid in by Shafiq, the proprietor	**2,500**
	24,250

Payments made in the year ended 31.12.1992:	Rs.
New plant purchased	625
Drawings	1,500
Wages	6,725
Salaries	1,125
Interest paid	75
Telephone	125
Rent 1,200	
Light and power	475
Sundry expenses	2,125
Sundry creditors (Purchases ledger accounts)	7,625
	21,600

ASSETS AND LIABILITIES

	as at 31.12.1991	as at 31.12.1992
Sundry creditors	2,525	2,400
Sundry debtors	3,750	6,125
Bank	625	3,275
Stock	6,250	3,125
Plant	7,500	7,315

From the above data prepare the profit and loss account for the year ended 31.12.1992 and the balance sheet as on that date.

Solution:

MOHAMMAD SHAFIQ
TRADING AND PROFIT AND LOSS ACCOUNT
for the year ended 31.12.1992

	Rs.			Rs.
Opening Stock	6,250	Sales:		
Purchases	7,500	Cash	4,125	
Light and Power	475	Credit	20,00 0	24,125
Wages	6,300	Closing stock		3,125
Gross Profit	6,725			
	27,250			27,250

Salaries	1,125	Gross Profit	6,300
Interest	75		
Telephone	125		
Rent	1,200		
Sundry expenses	2,125		
Depreciation	810		
Net profit transferred to capital account	840		
	6300		6300

BALANCE SHEET
as on 31st December, 1992

Assets		Rs.	Liabilities		Rs.
Bank		3,275	Sundry creditors		2,440
Sundry debtors		6,125	Capital:		
Stock		3,125	Opening balance	15,600	
Plant	7,500		Add additions	2,500	
Additions	625		Add Profit	840	
	8,125			18,940	
Less Depreciation	810	7,315	Less Drawings	1,500	17,440
		19,840			19,840

WORKING NOTES:

(1) Calculation of Credit Purchases

TOTAL CREDITORS ACCOUNT

	Rs.		Rs.
Cash account	7,625	Balance b/d	2,525
Balance c/d	2,400	Credit purchases (balancing figure)	7,500
	10,025		10,025

(2) Calculation of Credit Sales

TOTAL DEBTORS ACCOUNT

	Rs.		Rs.
Balance b/d	3,750	Cash account	17,625
Credit sales (balancing figure)	20,000	Balance c/d	6,125
	23,750		23,750

(3) **Calculation of Depreciation on plant**

PLANT ACCOUNT

	Rs.		Rs.
Balance b/d	7,500	Depreciation	810
Cash account	625	Balance c/d	7,315
	8,125		8,125

(4) **Calculation of capital on 1st January 1992**

BALANCE SHEET
as on 1.1.1992

Assets	Rs.	Liabilities	Rs.
Bank	625	Sundry creditors	2,525
Sundry debtors	3,750	Capital (balancing figure)	15,600
Stock	6,250		
Plant	7,500		
	18,125		18,125

ILLUSTRATION NO. 11

The Books of Mr. Sarwar on 1st January 1993 disclosed the following position.

Assets	Rs.	Liabilities	Rs.
Furniture	**2,000**	**Capital**	**8,000**
Sundry debtors	**9,000**	**Sundry creditors**	**7,500**
Stock	**4,000**		
Cash at bank	**500**		
	15,500		**15,500**

During the year 1993, the books were very imperfectly kept but an analysis of the bank transactions revealed the following:

	Rs.
Receipts from customers	**35,000**
Drawings for personal expenses	**6,000**
Payment of salaries	**3,000**
Payment to creditors	**22,000**
Payment for rent	**1,500**
Miscellaneous expenses	**400**

The schedules on 31.12.1993 of the debtors totalled Rs. 9,500 and of creditors Rs. 6,400. No inventory of the stock on 31.12.1993 was taken but it was stated that a gross profit at uniform rate of 40 per cent on turnover was made during the year.

Prepare a bank account, a trading and profit and loss account for the year and a balance sheet as on 31.12.1993.

Solution:

WORKINGS:

(a) Calculation of Credit Purchases

Cr. TOTAL CREDITORS ACCOUNT Dr.

	Rs.		Rs.
Cash	22,000	Balance b/d	7,500
Balance c/d	6,400	Credit purchases	20,900
		(balancing figure)	
	28,400		28,400

(b) Calculation of Credit Sales

TOTAL DEBTORS ACCOUNT

	Rs.		Rs.
Balance b/d	9,000	Cash	35,000
Credit sales	35,500	Balance c/d	9,500
(Balancing figure)			
	44,500		44,500

CASH BOOK

	Rs.		Rs.
Balance b/d	500	Drawings	6,000
Receipts from customers	35,000	Salaries	3,000
		Payments to creditors	22,000
		Rent	1,500
		Misc. expenses	400
		Balance c/d	2,600
	35,500		35,500

MR. SARWAR
TRADING AND PROFIT AND LOSS ACCOUNT
for the year ended December 31, 1993

	Rs.		Rs.
Opening stock	4,000	Sales (credit)	35,500
Credit purchases	20,900	Closing stock	3,600
Gross profit		(balancing figure)	
(40 % on sales)	14,200		
	39,100		39,100
Salaries	3,000	Gross profit	14,200
Rent	1,500		
Misc. expenses	400		
Net profit transferred to capital			
account	9,300		
	14,200		14,200

MR. SARWAR
BALANCE SHEET
as on 31st December 1993

Assets	Rs.	Liabilities		Rs.
Cash at bank	2,600	Creditors		6,400
Sundry debtors	9,500	Capital	8,000	
Stock	3,600	Add Net Profit	9,300	
Furniture	2,000		17,300	
		Less Drawings	6,000	11,300
	17,700			17,700

QUESTIONS

1. What do you understand by single entry system? What are its disadvantages?
2. Salman keeps his books by single entry. He has maintained the books of original entry and a ledger. He now desires to convert the books into double entry. Explain how this is to be done.
3. A client who has kept his books on single entry now desires to keep them on a complete double entry system under your instructions and supervision. Set out clearly and fully the instructions you would give your client bearing in your mind that he has not any knowledge of double entry book keeping.
4. Clearly distinguish between single entry and double entry system of accounts and bring out the disadvantages of the single entry system. Also explain how profits made during a particular period be ascertained under the single entry system.

SHORT PROBLEMS

1. **From the information given, calculate following:**

(a) Profit or loss during the year —

Capital in the beginning Rs. 15,600; capital at the end Rs. 14,000; drawings Rs. 4,800; capital introduced during the year Rs. 2,000. (Profit Rs. 1,200)

(b) Drawings during the year —

Capital in the beginning Rs. 20,000; capital introduced during the year 2,500; profit made during the year 1,500; capital at the end Rs. 20,500. (Rs. 3,500)

(c) Capital at the end __

Capital in the beginning Rs. 20,200; drawing during the year Rs. 4,000; capital introduced during the year Rs. 5,000; loss during the eyar Rs. 3,500. (Rs. 17,700)

(d) Capital in the beginning —

Capital at the end Rs. 30,000; drawing during the year Rs. 4,700; capital introduced during the year Rs. 3,000; profit during the year Rs. 6,000. (Rs. 25,700)

(e) Stock in the beginning —

Sales Rs. 2,40,000; percentage of gross profit on sales 20 % purchases Rs. 1,75,000; closing stock 30,000. (Rs. 47,000)

PROBLEMS

1. A trader keeps his books by the single entry method. His position on 31st December 1990 was as follows:
Cash at Bank Rs. 3,000; stock Rs. 20,000; Debtors Rs. 30,000; machinery Rs. 50,000; and creditors Rs. 23,000. His position on 31st December 1991 was as follows:
Cash at Bank Rs. 4,000; stock Rs. 25,000; Debtors Rs. 45,000; machinery Rs. 45,000; and creditors Rs. 25,000.
During the year, the trader introduced Rs. 10,000 as further capital in business and withdrew Rs. 300 per month.
From the above you are required to ascertain the profit or loss made by the trader for the year ended 31.12.1991.

Ans: *[Net Profit for the year Rs. 7600]*

2. The following balances appear in A's books which are kept on the single entry basis.

	31st Dec. 1994	31st Dec. 1995
Capital	50,000	48,000
Creditors	30,000	35,000
	80,000	83,000
Furniture	5,000	4,500
Stock	50,000	46,500
Debtors	20,000	23,000
Bank account	5,000	9,000
	80,000	83,000

A has been regularly transferring Rs. 600 a month from his business banking account to his private banking account by way of drawings. He has taken stock worth Rs. 1,500 for his private use. Depreciation on furniture has been provided at the rate of 10 per cent.

You are required to calculate A's profit for 1995.

Ans: *[Profit Rs. 6,700]*

3. Ansar commenced business on 1.7.1992 with a capital of Rs. 20,000. During the year ended 30.6.1993, he borrowed Rs. 5,000 from Mr. A and introduced a further capital of Rs. 2,000. Furniture worth Rs. 3,000 was purchased. He had drawn from the business a sum of Rs. 3,000 during the year. On 30.6.1993 the position was as follows:
Cash in hand Rs. 450; cash at bank Rs. 2,500; sundry debtors Rs. 4050; stock Rs. 7,000; bills receivable Rs. 1,800; sundry creditors Rs. 750.
Furniture is to be depreciated by 10 per cent. Ascertain the profit or loss made by Ansar during the year ended 30.6.1993.

Ans: *[Net Loss Rs. 6,250]*

4. Nawaz commenced business on 1st January, 1994 with a capital of Rs. 25,000. He immediately bought furniture and fixtures for Rs. 5,000. On 30th June, 1994, he borrowed Rs. 12,500 from his wife at 9 % per annum (interest not yet paid) and introduced a further capital of his own amounting to Rs. 3,750. Nawaz drew at the rate of Rs. 750 per month at the end of each month for household purposes. On 31st December, 1994 his position was as follows:

Cash in hand, Rs. 500; cash at bank, Rs. 6,500; sundry debtors, Rs. 12,000; stock Rs. 17,000; Bills receivable Rs. 4,000; sundry creditors, Rs. 1,250; and owing for Rent Rs. 375. Furniture and fixtures are to be depreciated by 10 %. Ascertain the profit or loss of Nawaz during 1994.

Ans: *[Profit for the year Rs. 10062]*

5. Mr. Saleem Hasan commenced business on 1st Jan., 1995, with a capital of Rs. 50,000. He immediately purchased furniture for Rs. 12000. On 1st April, 1995, he borrowed Rs. 30,000 from his friend Mr. Nasir @ 10 % p.a. and introduced a further capital of his own amounting to Rs. 19000. He had withdrawn Rs. 1800 at the end of each month for family expenses. On 31st, Dec. 1995, his position was as follows.

Cash in hand Rs. 1200, cash at bank Rs. 15600, sundry debtors Rs. 28800, stock Rs. 40800, B/R Rs. 9600, sundry creditors Rs. 3000, rent due Rs. 900.

Ascertain the profit or loss made by him after considering the following adjustments:

(1) Depreciate furniture @ 10 % p.a.
(2) Charge interest on capital @ 10 %.
(3) Interest is unpaid on Mr. Nasir Loan.
(4) Write off Rs. 2800 from sundry debtors.

Ans: *[Profit Rs. 14025].*

6. A retail trade does not keep double entry records. His business Balance Sheet at 1st January, 1995 was as follows:

BALANCE SHEET

Assets	Rs.	Liabilities	Rs.
Cash in hand	500	Creditors	4,000
Cash at bank	6,000	Capital	12,000
Stock	5,000		
Debtors	3,300		
Furniture	1,200		
	16,000		16,000

His position as at the end of the year 1995 was:

Cash in hand Rs. 500; cash at bank Rs. 5,000; stock Rs. 6,000; debtors Rs. 4,600; furniture Rs. 1,500 and creditors Rs. 6,000.

He withdrew during the year Rs. 9,000 out of which he spent Rs. 6,000 on the cost of purchasing a motor car for the business.

Prepare necessary statements to determine the net profits for the year and a balance sheet as at 31st December 1995 after making the following adjustments.

Depreciate furniture and motor car at the rate of 10 per cent, write off bad debts Rs. 200 and provide 5 per cent for doubtful debts.

Ans: *[Net Profit Rs. 7,430 Total Balance Sheet 22,430]*

7. Sagheer is not writing his books properly. From the following information prepare a statement showing profit or loss and statement of affairs for the year ending 30th June, 1991.

	1.7.1990	30.6.1991
Cash in hand	900	2800
Debtors	22800	21400
Creditors	31200	28400
Stock	33400	37400
Bills receivable	30500	28800
Bank overdraft	40800	39200
Motor van	4200	4200
Furniture	3400	3400

Drawings Rs. 4800; Depreciate furniture at 10 %. Write off Rs. 800 on motor van. Provide Rs. 1000 as bad debts and 5 % as reserve on debtors. Provide reserve of Rs. 1600 on Bills receivable.

Ans: *[Profit made for the year Rs. 7240]*

8. Nayyar keeps his books on single entry system. His statement of Assets and Liabilities as on 31st December 1990 is as follows:

Assets	Rs.	Liabilities	Rs.
Land and Buildings	20,000	Sundry Creditors	65,000
Furniture & Fixtures	3,000	Loan from Money lender	56,600
Plant & Machinery	55,000	Other liabilities	13,400
Stock	9,200		
Sundry Debtors	75,500		
Cash	8,300		
	1,71,000		1,71,000

His drawings during the year amount to Rs. 3,000. Land and Building are to be depreciated by 2 %, furniture and fixtures by 5 % and plant and machinery by 10 %. Sundry debtors are to be reduced by 2 %. He has used Rs. 800 worth of stock of his business for private purposes. During the year 1990 he sold some of his household furniture for Rs. 1,000 and paid this into his business Bank Account. His capital at the beginning of the year was Rs. 30,000. Draw up his statement of profit and loss of the year ended 31st December 1990.

Ans: *[Net Profit for the year Rs. 1240]*

9. The following balances are obtained from the books of Mr. Irfan as on 31st December, 2000 and 31st December, 1999.

	31-12-1999	31-12-2000
Sundry creditors	110,000	75,000
Furniture & Fixture	46,000	63,000
Office Equipments	48,000	47,700
Outstanding Expenses	2,500	5,880
Motor Car	47,000	37,600
Prepaid Expenses	1,400	2,500
Cash & Bank	45,000	38,000
Sundry Debtors	80,000	85,000
Stock in Trade	25,000	37,500
Bills payable	9,000	5,000

The following information is relevant for the year 2000.

(a) Cash drawings during the year amounted to Rs. 15,000 and goods costing rupees 6000 were taken by Mr. Irfan for his personal use.

(b) He sold one building at Karachi for Rs. 100,000 out of which he invested Rs. 25,000 in his business.

(c) One sales invoice amounting to Rs. 5,000 dated 1-10-2000 was omitted in books.

(d) Write off $6\frac{2}{3}$% from sundry debtors.

You are required to show by means of a statement as to how would you arrive at the Net Profit for the year ended 31st December, 2000 if the accounts were maintained on Cash Basis.

Ans: *[Net Profit Rs. 51800]*

10. X and Y carrying on business in partnership keep their books by single entry. On 1st January 1990, the statement of their position was:

Assets	Rs.	Liabilities & Capital		Rs.
Cash in hand	270	Bills payable		6,460
Cash at bank	2,190	Sundry creditors		20,280
Bills receivable	4,060	Capital accounts		
Sundry debtors	48,670	X	73,400	
Stock	32,850	Y	73,400	1,46,800
Plant and machiner	80,200			
Furniture	5,300			
	1,73,540			1,73,540

The following was the state of affairs on 31st December, 1990.

Cash in hand, Rs. 400, cash at bank Rs. 5,810, debtors Rs. 56,280, bills receivable Rs. 6,840, stock Rs. 36,730; creditors Rs. 21,470, bills payable Rs. 5,950.

The partners have drawn Rs. 4,800 each and were entitled to interest on capital at 6 per cent per annum. No interest was payable on drawings. It was agreed to depreciate plant and machinery at 10 per cent and furniture at 6 per cent.

Draw up a statement of profit and loss for the year ended 31st December 1990, and also a statement of affairs as on that date.

Ans: *[Net Profit Rs. 18602]*

11. Kamal, who keeps his books by single entry, submitted returns to the Income Tax Authorities showing his income to be as follows:

	Rs.
Year ending December 31st, 1989	14,700
Year ending December 31st, 1990	14,800
Year ending December 31st, 1991	15,740
Year ending December 31st, 1992	27,500
Year ending December 31st, 1993	24,280
Year ending December 31st, 1994	18,520

The income–tax officer is not satisfied as to the accuracy of the accounts submitted. You are instructed to assist in establishing their correctness, and for that purpose you are supplied with the following information:

(a) Business liabilities and assets at 31st December, 1988 were; Debtors, Rs. 2,900; Cash at bank and in hand Rs. 18,940; stock Rs. 10,840 (at selling price which is 25 % above cost); creditors Rs. 14,640.

(b) Kamal owed his brother, Rs. 8,000 on 31st December, 1988. On 15th February, 1991 he repaid this amount and on 1st January, 1994 he lent his brother Rs. 6,000.

(c) Kamal owns a house which he purchased in 1984; for Rs. 40,000 and a car which he purchased in 1990 for Rs. 15,000. In 1993 he bought Rs. 20,000 shares in X Ltd. for Rs. 15,000.

(d) In 1994 Rs. 6,000 were stolen from his house.

(e) Kamal estimates that his living expenses have been: 1989, Rs. 6,000; 1990, Rs. 8,000; 1991, Rs. 12,000; 1992, 1993 and 1994 Rs. 14,000 per annum exclusive of the amount stolen.

(f) On 31st December, 1994 the business Liabilities and Assets were: creditors Rs. 16,800, Debtors, Rs. 11,840; Cash in hand and at Bank, Rs. 38,900 and stock, Rs. 13,480 (at selling price which shows a gross profit of 25 %).

From the information submitted prepare a statement showing whether or not the income declared by Kamal is correct.

Ans: *[Profit actually earned but not revealed to Income Tax Authorities Rs. 30638]*

12. Barkat keeps his books on single entry principle. On 1st January, 1993 his assets and liabilities were as follows:

Capital Rs. 72,000; Sundry Creditors Rs. 18,500; Sundry Debtors Rs. 22,000; Machinery Rs. 34,000; Furniture Rs. 5,000; Stock Rs. 14,000.

The following is the cash book in respect of 1993:

Receipts	Rs.	Payments	Rs.
Balance b/d	15,500	Creditors	22,000
Received from debtors	40,000	Wages	6,000
Sales	12,000	Expenses	12,000
		Drawings	5,000
		Balance c/d	22,500
	67,500		67,500

On 31st December 1993 the sundry creditors were Rs. 20,000; sundry debtors Rs. 28,000, Machinery Rs. 34,000; Furniture Rs. 5,000 and stock Rs. 18,000.

Prepare Trading and Profit and Loss Account for the year ended 31st December 1993 and Balance Sheet after providing for depreciation on Machinery at 10 % and Furniture at 15 % interest on Capital at 5 % and 5 % on Debtors for doubtful debts.

Ans: *[Net Profit Rs. 11350; B/S Rs. 101950]*

13. Mr. Tipu keeps his books under Single Entry System. The position of his business as on 1st January 1992 was as under:

Sundry creditors, Rs. 17,000; Freehold premises, Rs. 50,000; stock, Rs. 25,000; Sundry Debtors, Rs. 20,000; Furniture, Rs. 2,000. An abstract of Cash Book is appended below:

Receipts	Rs.	Payments	Rs.
Sundry Debtors	15,000	Overdraft (1.1.1992)	10,000
Cash Sales	80,000	Expenses	50,000
		Drawings	3,000
		Sundry Creditors	20,000
		Cash in hand	2,000
		Cash at Bank	10,000
	95,000		95,000

The following additional information is available:

Closing stock, Rs. 30,000; Closing Debtors, Rs. 25,000; closing creditors, Rs. 12,000. No additions were made during the year to Premises and Furniture Account, but they are to be depreciated at 10 % and 15 % respectively. A bad debts reserve of $2\frac{1}{2}$ % is to be raised.

Prepare a Trading and Profit and Loss Account for the year ended 31st December, 1992 and a Balance Sheet as on that date.

Ans: *[Net Profit Rs. 34075; B/S Rs. 113075]*

14. Mahmood keeps his books by Single Entry and desires you to prepare Profit and Loss Account for the year ended 30th September, 1992 together with a Balance Sheet as on that date, upon analysing the cash book for the year, you find the following:

	Rs.		Rs.
Receipts from Debtors	78,000	Bank overdraft on 1st Oct., 1991	12,500
Received from Cash Sales	48,000	Interest on Bank Overdraft	525
		Drawings	7,000
		Manager's salary	4,000
		Staff Salaries	24,000
		General Expenses	24,275
		Paid to Trade Creditors	46,000
		Balance at Bank on 30th Sept. 1992	7,275
		Balance with cashier on 30th Sept. 1992	425
	1,26,000		1,26,000

His capital on 1st October, 1991 was Rs. 1,10,000, stock Rs. 28,500. Debtors Rs. 68,000. Furniture Rs. 4,000. Business Premises Rs. 48,000 and Creditors Rs. 26,000. On 30th September, 1992 his stock was Rs. 32,660. Debtors Rs. 92,000. Furniture Rs. 4,000 Premises Rs. 48,000, Creditors Rs. 18,500.

From the above figures, prepare final accounts after writing off 5 % on furniture and 10 % on business premises Rs. 3,500 for Doubtful debts and 5 % interest on Capital.

Ans: *[Net Profit Rs. 48860; B/S Rs. 175860]*

15. Sadaqat supplies you the following information:

	1st January 1993 Rs.	31st December 1993 Rs.
Sundry debtors	10,050	10,650
Stock	8,500	9,000
Machinery	14,500	
Furniture	3,000	
Sundry Creditors	4,000	7,250

SUMMARY _ F CASH TRANSACTIONS FOR 1993

Receipts	Rs.	Payments	Rs.
Opening balance	2,750	Payments to creditors	18,500
Cash sales	3,550	Wages	8,500
Received from debtors	38,650	Salaries	8,000
Miscellaneous receipts	1,100	Drawings	2,000
Loan from Naeem at 9 %		Expenses	6,000
on 1st July	4,000	Machinery Purchased	
		(1st July)	5,250
		Closing Balance	1,800
	50,050		50,050

Discounts allowed were Rs. 450 and discounts received were Rs. 300. Bad debts written off were Rs. 500. Depreciation is to be written off on furniture at 6 % and Machinery at 10 % wages, Rs. 1,000 are still due. Expenses include insurance at Rs. 300 per annum paid up to 31st March 1994. Prepare Trading and Profit and Loss Account and Balance Sheet relating to 1993.

Ans: *[Net Loss Rs. 2848; B/S Rs. 42382]*

16. Mr. Naeem commenced business on 1st January 2000 with a capital of R. 70,000. He purchased furniturey on 1st April 2000 for cash Rs. 15000. On 1st July he purchased premises for cash Rs. 50,000.

From the following details obtained from his books by single entry, you are asked to prepare a Trading and Profit and Loss Account for the year ending 31st December, 2000 and a balance sheet as on that data after providing depreciation on furniture and premises @ 10% p.a.

Sales (Inclusive of Cash Rs. 45000)	Rs. 100,000
Purchases (Exclusive of cash Rs. 10,000)	Rs. 25,000
Drawings	5,000
Wages	8,000
Rent	6,000
Salaries	28,000
Bad Debts written off	2,500

Naeem took goods worth Rs. 4000 from business and paid Rs. 1500 to his son, but omitted to record these transactions in his books. On 31st December, 2000 his Debtors were Rs. 29,000 and creditors Rs. 14000. Stock on that date was Rs. 20,000.

Ans: *[Net Profit Rs. 40875; B/s Rs.114375]*

17. Miss Shazia keeps her books on Single Entry System of book-keeping. From the following particulars prepare Trading Account, Profit and Loss Account for the period ended with 31st December 1990 and a Balance Sheet as on that date. On 1st January 1990 her assets and liabilities were as follows; Machinery Rs. 60,000; stock Rs. 50,000; sundry debtors Rs. 60,000; Furniture Rs. 5,000; sundry creditors Rs. 30,000; and Bank overdraft Rs. 10,000. The cash book of Miss Shazia gives the following information:

	Rs.
Receipts from Debtors	80,000
Cash Sales	30,000
Payment to creditors	40,000
Cash purchases	25,000
Interest on Bank overdraft	1,500
Salaries	5,000
Drawings	4,000
General Expenses	8,000
Rent	2,200

Discount allowed to debtors was Rs. 4,000 and discount received from creditors was Rs. 2,500. Goods worth Rs. 3,000 were returned by the customers and goods worth Rs. 2,500 were returned to her suppliers. On 31st December, 1990, her position of assets and liabilities was as follows:

Stock Rs. 45,000; sundry debtors Rs. 70,000; Bills receivable Rs. 6,000; Bills payable Rs. 4,000; Machinery Rs. 60,000; Furniture Rs. 5,000; Sundry creditors Rs. 25,000; and salary outstanding Rs. 500. Depreciate Machinery at 10 % and furniture at 6 per cent.

Ans: *[Net Profit Rs. 33500; B/S Rs. 194000]*

18. Mr. Mukhtar keeps his books under Single Entry System. From the following information prepare Trading and Profit and Loss Account for the year ending 30th September, 1991 and the Balance Sheet as on that date.

ANALYSIS OF THE CASH BOOK

	Rs.
Bank overdraft on 1.10.1990	8,000
Interest on the above	150
Mukhtar drawings	4,000
Manager's salary	4,000
Salaries and wages	13,000
Business Expenses	15,800
Paid to Creditors	30,000
Balance at Bank	4,850
Cash in hand	200
Receipts from debtors	50,000
Receipts from cash sales	30,000

ADDITIONAL INFORMATION

	1.10.1990	30.9.1991
Stock	Rs. 18,000	Rs. 20,440
Creditors	16,000	11,000
Debtors	44,000	60,000
Business premises	32,000	32,000

Mukhtar's capital on 1st October 1990 was Rs. 70,000. Calculate interest on capital at 5 per cent. Provide a reserve of Rs. 3,000 for bad debts on debtors. Depreciate Business premises at 5 per cent.

Besides his salary Manager is eligible for 5 per cent, commission on net profit after charging such commission.

Ans: *[Net Profit Rs. 30848; B/S Rs. 112890]*

NOTE:

The students are advised to prepare a cash account as and when it is not given in the question; and verify the Opening Balance Sheet correctness.

19. **Waris keeping his books under Single Entry System has placed the following facts before you:**

(i) His statement of affairs as on 1st January 1994.
(ii) A summary of cash transactions for the year, 1994.
(iii) A list of remaining transactions for the year.

(i)

Assets		Rs.	Liabilities	Rs.
Debtors	75,000		Bank overdraft	25,000
Less: Provision	3,750	71,250	Creditors	50,000
Bills receivable		18,000	Bills payable	3,000
Stock		70,000	Outstanding General Charges	2,000
Plant		50,000	Capital Account	1,52,000
Buildings		20,000		
Cash in hand		2,750		
		2,32,000		2,32,000

(ii)

	Rs.		Rs.
Balance on 1.1.1994	2,750	Payment to creditors	1,80,000
Bills receivable	50,000	Cash purchases	40,000
Debtors	2,18,000	Bills payable	80,000
Cash sales	41,000	Salaries	15,000
Mrs. Waris's Loan	25000	Rent	9,500
		General Charges	4,500
		Drawings	5,400
		Balance c/d	2,850
	3,36,750		3,36,750

(iii)

	Rs.
Total sales	4,02,500
Total purchases	3,60,000
Discount allowed to customers	1,000
Discount allowed by creditors	2,000
Bills receivable as on 31.12.1994	30,000
Bills payable accepted during the year	93,000
Stock on 31.12.1994	85,000
Owing for outstanding general charges	3,000
Bad debts	2,000
Prepaid rent	1,800

Provide 5 % for doubtful debts and $2\frac{1}{2}$ % for discount on debtors. Depreciate Buildings by 2 % and plant by 10 per cent.

You are required to prepare Trading and Profit and Loss Account and Balance Sheet of Waris from the above particulars.

Ans: *[Net Profit Rs. 15829; B/S Rs. 326429]*

20. From the following particulars prepare Trading and Profit & Loss Account for the year ending 31st March 1994.

BALANCE SHEET AS ON 31.3.1993

	Rs.		Rs.
Creditors	10,000	Cash	2,500
Bills payable	20,000	Bank	5,000
Capital	50,000	Bills receivable	10,000
		Debtors	12,500
		Stock	10,000
		Furniture	5,000
		Plant	35,000
	80,000		80,000

CASH TRANSACTIONS DURING THE YEAR:

	Rs.		Rs.
Balance:		Drawings	6,000
Cash	2500	Wages	10,000
Bank	5,000	Creditors	17,500
Cash sales	17,500	Bills paid	30,000
Receipts from debtors	40,000	Sundry expenses	15,000
Bills receivable	37,500	Rent, rates and taxes	10,000
		Balance	
		Cash	1,500
		Bank	12,500
	1,02,500		1,02,500

Additional Informations:

	Rs.
Debtors on 31.3.1994	20,000
Creditors on 31.3.1994	12,500
Bills receivable on 31.3.1994	15,000
Bills payable on 31.3.1994	25.000
Bill receivable in hand dishonored	2500
Bill payable dishonored	1000
Bill receivable endorsed	7500
Bill receivable endorsed dishonored	1500
Discount allowed	500
Discount received	1000
Closing Stock	15,000

Ans: *[Profit: 22500, B/S Rs. 104,000].*

CHAPTER - 17

THE ACCOUNTS OF NON-PROFIT MAKING ORGANISATIONS

THE ACCOUNTS OF NON – PROFIT MAKING ORGANISATIONS

What Non–Profit Making Organizations are?

People Join together for a number of reasons in voluntary organization: for mutual entertainment, for protection, or for professional reasons. There are sports clubs, trade unions, consumer societies, political associations, and many more. The degree of richness of any society lies partly in the variety of the voluntary organization it promotes.

Non–profit making organization are those, which do not buy/manufacture and sell goods and whose primary object is not to earn profit. Their object is to do good to the society through welfare activities; e.g. clubs, schools, colleges, Hospitals, Libraries etc.

From the book–keeping point of view the aim of such organizations is the pursuit of some interest other than financial benefit, so these may be termed as Non–Profit making Organizations. Although these organization are not meant for profit earning, yet organizations of this sort must have funds to promote their activities, and these funds must be honestly accounted for. For example in case of a club, the official elected for this purpose is called the "Treasurer", one of the key figures on the committee which is elected to run the club. The others are the secretary, responsible for organizing the club's activities, and the chairperson, or president, who controls the meetings.

The treasure's functions are to collect subscriptions, disburse such funds as are needed in the course of the activities, and report to the members when required, but especially at the annual General Meeting — an important occasion in the club's life. At this meeting the activities of the club are reviewed, criticisms are voiced, or praise is accorded the committee.

How Activities are Accounted for? — An example of a club

Clubs rarely keep a full set of Ledger Accounts, but some clubs are very large indeed and need just as huge an organization as any other large scale business. Such huge organizations can hardly conduct their affairs with a simple Cash Book, yet many club treasurers in small clubs do exactly that, while bigger clubs usually have just a Cash Book with analysis columns. This analytical Cash Book is a basic club record or "book of original entry. But most of the clubs maintain a simple Cash Book as by business concerns.

In this type of book the treasurer keeps a record of all sums received and paid; and analyses them into various sub–headings as he goes along. All cash transactions are first recorded in the Cash Book, then posting is made into the Ledger and Finally Trial Balance is prepared. Rest of the transactions are entered in General Journal. Now see how we record the transactions of a club in the books of accounts and prepare Final Accounts at the end.

ILLUSTRATION NO. 1

On 1.1.95 a club is established and its transactions during the year 1995 were as follows:

1995		Rs.	1995		Rs.
Jan. 1	Collected donation	100	Apr. 15	Donation	300
Jan. 2	Paid rent	100	Apr. 20	Newspaper	18
	Admission fee	20	May 25	Sale of old newspaper	15
	Subscription	650		Postage	8
Jan. 20	Purchased furniture on		Jan. 13	Electric charges	35
	credit from Rafi & Co.	250	Jan. 15	Purchased bats & balls	75
Feb. 2	Paid salaries	260		Meeting expenses	30
Feb. 4	Paid to Rafi & Co.	100	Aug. 10	Subscription	410
Feb. 28	Purchased books	300	Sept. 5	Paid to Rafi & Co.	100
	Newspapers	22	Oct. 15	Printing & stationery	30
Mar. 6	Traveling expenses	20	Nov. 10	Salaries	360
	Admission fee	15	Dec. 5	Paid rent	200
Apr. 2	Subscription	480	Dec. 28	Electric charges	30

The following additional information is available:

(1) Subscription received in advance Rs. 20.

(2) Subscription accrued Rs. 45.

(3) Salaries outstanding Rs. 60.

(4) Rent paid in advance Rs. 40.

(5) Depreciate furniture & books @ 10 % p.a.

Write the books of the club and prepare Final Accounts on 31.12.1995.

Solution:

CASH BOOK

Dr. **Cr.**

Date	Particulars	L/R	Amount Rs.	Date	Particulars	L/R	Amount Rs.
1995				1995			
Jan. 1	Donation A/c		100	Jan. 2	Rent A/c		100
Jan. 2	Admission Fee A/c		20	Feb. 2	Salaries A/c		260
Jan. 2	Subscription Account		650	Feb. 4	Rafi & Co. A/c		100
				Feb. 28	Book A/c		300
Mar. 6	Admission Fee A/c		15	Feb. 28	Newspapers A/c		22
Apr. 2	Subscription Account		480	Mar. 6	Traveling Expenses A/c		20
Apr. 15	Donation A/c		300	Apr. 20	Newspapers A/c		18
May 25	Miscellaneous Income A/c		15	May 25	Postage A/c		8
				June 13	Electric Charges A/c		35
Aug. 10	Subscription A/c		410	July 15	Bats and Balls A/c		75
				July 15	Meeting Expenses A/c		30
				Sept. 5	Rafi & Co. A/c		100
				Oct. 15	Printing & Stationery A/c		30
				Nov. 10	Salaries A/c		360
				Dec. 5	Rent A/c		200
				Dec. 28	Electric Charges A/c		30
				Dec. 31	Balanced c/d		302
			1,990				1,990
1996							
Jan. 1	Balance b/d		302				

GENERAL JOURNAL

Date	Details		L/R	Dr. Amount Rs.	Cr. Amount Rs.
1995					
Jan. 20	Furniture Account	... Dr.		250	
	Rafi & Co. Account				250
	(Being furniture purchased on credit)				
Dec. 31	Depreciation Account	... Dr.		50	
	Furniture Account				25
	Books Account				25
	(Being depreciation charged @ 10 % p.a.)				
"	Subscription Account	... Dr.		20	
	Subscription received in Advance Account				20
	(Being subscription received in advance adjusted)				
"	Accrued Subscription Account	... Dr.		45	
	Subscription Account				45
	(Being subscription accrued for current year adjusted)				

1. Books were purchased on 28.2.95; so depreciation thereon will be charged for 10 months (March to December).

				Dr.	Cr.
1995				Rs.	Rs.
Dec. 31	Salaries Account	... Dr.		60	
	Outstanding Salaries Account				60
	(Being salaries outstanding for current year adjusted)				
"	Prepaid Rent Account	... Dr.		40	
	Rent Account				40
	(Being rent paid in advance adjusted)				

"	Income & Expenditure Account ... Dr.		1,258	
	Rent Account			260
	Salaries Account			680
	Traveling Expenses Account			20
	Newspapers Account			40
	Postage Account			8
	Electric Charges Account			65
	Meeting Expenses Account			30
	Bats & Balls Account			75
	Depreciation Account			30
	(Being transfer of the above accounts to Income & Expenditure Account)			50
"	Donation Account ... Dr.		400	
	Admission Fee Account ... Dr.		35	
	Subscription Account ... Dr.		1,265	
	Miscellaneous Income Account ... Dr.		15	
	Income & Expenditure Account			1,715
	(Being transfer of the above accounts to Income & Expenditure Account)			
"	Income & Expenditure Account ... Dr.		757	
	Capital Fund Account			757
	(Being transfer of the excess of income over expenditure to Capital Fund Account)			

NOTE 1:

The each transactions have been record primarily in Cash Book and other transactions in Journal. Thereafter only one aspect of the cash transactions has been posted in Ledger. The other aspect being concerned with Cash Account, needs no posting in Ledger, since entries in Cash Book are a part of Double Entry. But in respect of other transactions both the aspects (debit & credit) have been posted in Ledger.

NOTE 2:

Income and Expenditure Account is prepared in the same way as Profit & Loss Account in trading concerns. The detailed discussion about this account has been made later in this chapter.

LEDGER
Subscription Account

Dr. Cr.

Date	References	J/R	Amount Rs.	Date	References	J/R	Amount Rs.
				1995			
Dec. 31	Subscription Received in Advance A/c		20	Jan. 2	Cash A/c		650
				Apr. 2	Cash A/c		480
				Aug. 10	Cash A/c		410
"	Income & Expenditure A/c		1,565	Dec. 31	Accrued Subscription A/c		45
			1,585				1,585

ADMISSION FEE ACCOUNT

Dr. Cr.

1995			Rs.	1995			Rs.
Dec. 31	Income & Expenditure A/c		35	Jan. 2	Cash A/c		20
				Apr. 15	Cash A/c		15
			35				35

DONATION ACCOUNT

Dr. Cr.

1995			Rs.	1995			Rs.
Dec. 31	Income & Expenditure A/c		400	Jan. 2	Cash A/c		100
				Apr. 15	Cash A/c		300
			400				400

MISCELLANEOUS INCOME ACCOUNT

Dr. Cr.

1995			Rs.	1995			Rs.
Dec. 31	Income & Expenditure A/c		15	May 25	Cash A/c		15
			15				15

SALARIES ACCOUNT

Dr. Cr.

			Rs.				Rs.
1995				1995			
Feb. 2	Cash A/c		260	Dec. 31	Income &		
Nov. 10	Cash A/c		360		Expenditure A/c		680
Dec. 31	Outstanding						
	Salaries A/c		60				
			680				680

RENT ACCOUNT

Dr. Cr.

1995			Rs.	1995			Rs.
Jan. 2	Cash A/c		100	Dec. 31	Prepaid		
Dec. 3	Cash A/c		200		Rent A/c		40
				"	Income &		
					Expenditure A/c		260
			300				300

ELECTRIC CHARGES ACCOUNT

Dr. Cr.

1995			Rs.	1995			Rs.
June 13	Cash A/c		35	Dec. 31	Income &		
Dec. 2	Cash A/c		30		Expenditure A/c		65
			65				65

TRAVELLING EXPENSES ACCOUNT

Dr. Cr.

1995			Rs.	1995			Rs.
Mar. 6	Cash A/c		20	Dec. 31	Income &		
					Expenditure A/c		20
			20				20

NEWSPAPERS ACCOUNT

Dr. Cr.

			Rs.				Rs.
1995				1995			
Feb. 28	Cash A/c		22	Dec. 11	Income &		
Apr. 20	Cash A/c		18		Expenditure A/c		40
	c/o		40				40

POSTAGES ACCOUNT

Dr. Cr.

1995			Rs.	1995			Rs.
May 25	Cash A/c		8	Dec. 31	Income &		
					Expenditure A/c		8
			8				8

MEETING EXPENSES ACCOUNT

Dr. Cr.

1995			Rs.	1995			Rs.
July 15	Cash A/c		30	Dec. 31	Income &		
					Expenditure A/c		30
			30				30

BATS & BALLS ACCOUNT

Dr. Cr.

1995			Rs.	1995			Rs.
July 15	Cash A/c		75	Dec. 31	Income &		
					Expenditure A/c		75
			75				75

PRINTING & STATIONERY ACCOUNT

Dr. Cr.

1995			Rs.	1995			Rs.
Oct. 15	Cash A/c		30	Dec. 31	Income &		
					Expenditure A/c		30
			30				30

BOOKS ACCOUNT

Dr. **Cr.**

			Rs.				Rs.
1995				1995			
Feb. 28	Cash A/c		300	Dec. 31	Depreciation A/c		25
					Balance c/d		275
			300				300
1996							
Jan. 1	Balance b/d		275				

FURNITURE ACCOUNT

Dr. **Cr.**

			Rs.				Rs.
1995				1995			
Jan. 20	Rafi & Co.		250	Dec. 31	Depreciation A/c		25
					Balance c/d		225
			250				250
1996							
Jan. 1	Balance b/d		225				

RAFI & CO. ACCOUNT

Dr. **Cr.**

			Rs.				Rs.
1995				1995			
Feb. 4	Cash		100	Jan. 20	Furniture A/c		250
Sept. 5	Cash		100				
Dec. 31	Balance c/d		50				
			250				250
				1996	Balance c/d		50

DEPRECIATION ACCOUNT

Dr. **Cr.**

			Rs.				Rs.
1995				1995			
Dec. 31	Furniture A/c		25	Dec. 31	Income & Expenditure A/c		50
	Books A/c		25				
			50				50

SUBSCRIPTION RECEIVED IN ADVANCE ACCOUNT

Dr. Cr.

			Rs.				Rs.
1995				1995			
Dec. 31	Balance c/d		20	Dec. 31	Subscription A/c		20
			20				20
				1996			
				Jan. 1	Balance c/d		20

ACCRUED SUBSCRIPTION ACCOUNT

Dr. Cr.

			Rs.				Rs.
1995				1995			
Dec. 31	Subscription A/c		45	Dec. 31	Balance c/d		45
			45				45
1996							
Jan. 1	Balance b/d		45				

OUTSTANDING SALARIES ACCOUNT

Dr. Cr.

			Rs.				Rs.
1995				1995			
Dec. 31	Balance c/d		60	Dec. 31	Salaries A/c		60
			60				60
				1996			
				Jan. 1	Balance b/d		60

PREPAID RENT ACCOUNT

Dr. Cr.

			Rs.				Rs.
1995				1995			
Dec. 31	Rent A/c		40	Dec. 31	Balance b/d		40
			40				40
1996							
Jan. 1	Balance b/d		40				

CAPITAL FUND ACCOUNT

Dr. **Cr.**

			Rs.				Rs.
1995 Dec. 31	Balance c/d		757	1995 Dec. 31	Income & Expenditure A/c		757
			757				757
				1996 Jan. 1	Balance b/d		757

Now Trial Balance is to be prepared in order to ensure that the transactions have been recorded correctly in Ledger.

Trial Balance as on 31.12.1995

Name of Account	Ledger Reference	Debit Rs.	Credit Rs.
Subscription Account			1,565
Admission Fee Account			35
Donation Account			400
Miscellaneous Income Account			15
Salaries Account		680	
Rent Account		260	
Electric Charges Account		65	
Traveling Expenses Account		20	
Newspapers Account		40	
Postages Account		8	
Meeting Expenses Account		30	
Bats & Balls Account		75	
Printing & Stationery Account		30	
Books Account		275	
Furniture Account		225	
Rafi & Co. Account			50
Depreciation Account		50	
Subscription Received in Advance Account			20
Accrued Subscription Account		45	
Outstanding Salaries Account			60
Prepaid Rent Account		40	
Cash Account		302	
		2,145	2,145

It is to be noted here that Capital Fund Account and Income & Expenditure Account have not been included in Trial Balance. It is because these two accounts have been prepared after the Trial Balance has been prepared.

Since the Trial Balance has agreed, we may assume that the books of account are correct. However, a few types of errors may remain undetected even if the Trial Balance agrees.

Now let us prepare the Final Accounts of the club, i.e.,

1. Income & Expenditure Account, and
2. Balance Sheet

Income & Expenditure Account
for the year ended 31st December 1995

Dr. Cr.

Expenditure		Rs.	Income		Rs.
Salaries	620		Subscription	1,540	
Add Outstanding	60	680	Add Accrued	45	
Rent	300			1,585	
Less Prepaid	40	260	Less Received in		
Electric Charges		65	advance	20	1,565
Traveling Expenses		20	Admission Fee		35
Newspapers		40	Donation		400
Postages		8	Miscellaneous Income		
Meeting Expenses		30	– Sale of old newspaper		15
Bat & Balls		75			
Printing & Stationery		30			
Depreciation on:					
Furniture (10 % of					
Rs. 250)	25				
Books (10 % p.a. of					
Rs. 300 for 10 months)	25	50			
Capital Fund					
– Excess of Income over					
Expenditure transferred		757			
		2,015			2,015

Balance Sheet as on 31st December 1995

Assets		Rs.	Liabilities	Rs.
Furniture	250		Capital Fund	757
Less Depreciation @ 10 %	25	225	(Excess of income over	
Books	300		Expenditure)	
Less Depreciation @ 10 %	25	275	Creditors (Rafi & Co.)	50
Cash in hand		302	Subscription received	
Accrued Subscription		45	in advance	20
Prepaid Rent		40	Outstanding Salaries	60
		887		887

RECEIPTS AND PAYMENTS ACCOUNT

Generally, in examination problems an account styled "Receipts & Payments Account" and some additional information are given with the help of which Final Accounts are to be prepared. Now let us see what Receipts & Payments Account is? All the information necessary for preparation of this account is available from Cash Book. Various cash receipts and cash payments during the whole year find place in this account in a classified manner. Its closing balance indicates cash in hand and cash at bank at the year-end. It may be noted that Receipts & Payments Account cannot disclose the true result of a concern – it is ascertained through Income & Expenditure Account.

DEFINIITONS:

1. "A Receipts and payments Account is a summarized Cash Book (cash and bank) for a given period". — Spicer and Pegler.

2. "This (Receipts and Payments Account) is simply a summary of the cash transactions as in the Cash Book, analyzed and classified under suitable headings, including the opening and closing balances". — R.N. Carter.

Thus the account which is prepared at the year end in a summarized form with all the cash receipts and cash payments during the year arranged in a classified form, is called Receipts and Payments Account.

CHARACTERISTICS:

The following are the features of Receipts and Payments Account:

(1) It is an abridged edition of Cash Book __ it is, in effect, a summary of Cash Book.

(2) All cash receipts during the whole year are recorded on its left–hand (i.e., Debit) side, while all cash payments during the whole year are written on its right–hand (i.e. Credit) side, arranged in a classified form.

(3) Cash receipts and cash payments of both capital and revenue nature are recorded here.

(4) Only cash transactions are recorded here.

(5) It will generally show debit balance. In case of bank overdraft balance, however, its net balance may be credit. Again, it may also show nil balance ___ but such occasion is rare.

(6) Its closing balance indicates closing cash in hand and closing cash at bank.

(7) It is not an account within the Double Entry System ____ it is a statement only.

(8) It is prepared on the last day of the accounting year.

ADVANTAGES:

The following advantages are derived from Receipts and Payments Account:

(1) Total receipts and total payments under various heads are available at a glance.

(2) The amount of cash in hand at the year-end can be ascertained.

(3) The correctness of Cash Book can be verified through it. The total of Debit side of Cash Book will agree with that of Receipts side of Receipts and Payments Account. On the other hand, the total of Credit side of Cash Book will agree with that of Payments side of Receipts and Payments Account.

METHOD OF PREPARATION:

Receipts and Payments Account is prepared with all the cash receipts and cash payments of the whole year. The net result of cash receipts and cash payments of a fixed period of time is determined through this account. So it's heading will be:

Receipts and Payments Account for the year ended 31.12.1995

(If accounting year ends on 31.12.1995)

Its left–hand side is called "Receipts" and right–hand side "Payments". On the left–hand (i.e. Receipts) side all cash receipts are recorded, while on the right–hand (i.e. Payments) side all cash payments are written, arranged in a classified form. It starts with last year's closing cash in hand and cash at bank and closes with current year's closing cash in hand and cash at bank. In other words, its opening balance indicates last year's closing cash in hand and cash at bank, while its closing balance means current year's closing cash in hand and cash at bank.

DISTINCTION BETWEEN CASH BOOK AND RECEIPTS AND PAYMENTS ACCOUNT

In fact Receipts and Payments Account is the Cash Book in a summarized form. Yet certain distinctions are observed between the two:

	Cash Book		Receipts & Payments Accounts
1.	It is a book of account within the Double Entry System.	1.	It is an account outside the Double Entry System.
2.	Each transaction is recorded here separately in chronological (according to date) order.	2.	Each transaction is not recorded separately ___ all the transactions are recorded at a time at the end of accounting year in a classified form.
3.	Each entry is followed by narration.	3.	No narration is written here.
4.	Ledger reference recorded here.	4.	No ledger reference is recorded here.
5.	Daily cash balance can be ascertained from this book.	5.	Daily cash balance cannot be ascertained.
6.	All concerns (non–profit–seeking & profit–seeking) prepare it.	6.	Only non–profit–seeking concerns prepare it.
7.	Whenever a cash transaction takes place, it is recorded in this book. In other words, it is a current account.	7.	It is prepared on the last day of a year. In other words, it is a periodical account.
8.	It is a must.	8.	It is not indispensable —it may not be prepared.

NOTE:

Cash balance at the year-end can be ascertained from both the accounts. It hardly needs any mention that the balances of the two accounts will always be equal.

ILLUSTRATION NO. 2

From the following Cash Book of ABC Club prepare a Receipts and Payments Account for the year ended 31st December 1995.

Dr. **Cash Book** **Cr.**

Date	References	L/R	Amount Rs.	Date	References	L/R	Amount Rs.
1995				1995			
Jan. 1	Balance b/d		250	Jan. 5	Rent		200
Feb. 2	Subscription		600	Jan. 16	Traveling		
Mar. 10	Admission Fee		25		Expenses		15
Apr. 5	Subscription		950	Feb. 12	Salaries		250
May 20	Sale of old			Mar. 17	Entertainment		
	newspaper		10		Expenses		50
June 3	Subscription		880	Apr. 20	Electric Charges		20
July 15	Admission Fee		30	May 5	Furniture		300
Aug. 20	Sale of old			May 10	Postage		18
	newspaper		15	June 3	Stationery		120
Sep. 5	Donation		100	July 12	Electric Charges		30
Oct. 1	Sale of old			Aug. 3	Newspaper		25
	Furniture		150	Sep. 15	Salaries		320
Nov. 15	Donation		50	Sep. 20	Newspaper		65
Dec. 28	Subscription		250	Oct. 3	Traveling		
					Expenses		25
				Oct. 12	Postage		12
				Nov. 5	Rent		300
				Nov. 16	Entertainment		
					Expenses		80
				Dec. 5	Books		450
				Dec. 12	Salaries		350
				Dec. 25	Rent		130
				Dec. 31	Balance c/d		550
			3,310				3,310
1996							
Jan. 1	Balance c/d		550				

Solution:

ABC Club
Receipts & Payments Account
for the year ended 31st December, 1995

Dr. **Cr.**

Receipts	Rs.	Payments	Rs.
Balance b/d	250	Rent [200 + 300 + 130]	630
Subscription [600+950+880+250]	2,680	Traveling Expenses [15 + 25]	40
Admission Fee [25 + 30]	55	Salaries [250 + 320 + 350]	920
Sale of old newspaper [10 + 15]	25	Entertainment Expenses	
Donation [100 + 50]	150	[50 + 80]	130
Sale of old Furniture	150	Electric Charges [20 + 30]	50
		Furniture	300
		Postage [18 + 12]	30
		Stationary	120
		Newspaper [25 + 65]	90
		Books	450
		Balance c/d	550
	3,310		3,310
Balance b/d	550		

INCOME AND EXPENDITURE ACCOUNT

All transactions relating to non–profit-seeking concerns like Club, Library etc. are recorded in the books of account strictly according to Double Entry System. At the year-end result is determined through Final Accounts. Final Accounts consist of two stages:

1. Income and Expenditure Account
2. Balance Sheet.

These are discussed below in details.

1. INCOME AND EXPENDITURE ACCOUNT

All the information necessary for preparation of this account will be available from ledger accounts. Its left–hand (i.e. Debit) side records all revenue expenditure, while the right–hand (i.e. Credit) side records all revenues relating to the current year. The balance of the account, if credit, indicates surplus, i.e. excess of income over expenditure. Conversely, the balance of the account, if debit, indicates deficit, i.e. excess of expenditure over income.

DEFINITION:

The account through which surplus or deficit of a non–profit–seeking concern is ascertained, is called Income and Expenditure Account.

CHARACTERISTICS:

The following are the characteristics of Income and Expenditure Account:

(1) It is in fact the Profit and Loss Account of a profit–seeking concern.

(2) All expenses are recorded on Debit side and all revenues on Credit side.

(3) Only revenue transactions are included in it. No capital items is taken into account.

(4) All the items of income/revenue concerning current year — whether received in cash or not — and all items of expense — whether paid in cash or not — are taken into account. But no item of income or expense concerning last year or next year is included in it.

(5) Surplus or deficit of a concern is ascertained through this account. Credit balance indicates surplus, while debit balance indicates deficit.

(6) Its balance is transferred to Capital Fund Account.

(7) It is prepared on the last day of an accounting year.

(8) It does not start with any opening balance.

METHOD OF PREPARATION:

The following points are to be noted, while preparing the above account:

1. Surplus or deficit of a fixed period of time is ascertained through this account. So it's heading will be:

   Income and Expenditure Account for the year ended 31.12.1995.

   (If the accounting year closes on 31.12.1995).

2. Income and Expenditure Account is a Nominal Account. Hence, only revenue (no capital) items will find place in it.

3. All items of revenue income and expenditure relating to the current year will appear in it. In other words, all items of income relating to the current year – whether received in cash or not – and all items of expenditure relating to the current year – whether paid in cash or not – will find place in this account. No items of income or expenditure relating to last year or next year will be included in this account.

SOME PECULIAR ITEMS OF A NON–PROFIT SEEKING CONCERNS

1. DEPRECIATION:

Depreciation means loss on account of use of an asset or decrease in its value on account of passage of time. Suppose, an almirah is bought for Rs. 1,000. Its value must diminish gradually on account of use – the more it is used, the more will it diminish in value. After sometime it will become unfit for use. Then a new almirah is to be bought. Suppose, the almirah can be used for 10 years. In that case the annual loss on account of depreciation will be Rs. 100 (1,000 ÷ 10). It must be debited to Income and Expenditure Account; otherwise the true result cannot be obtained. Similarly, depreciation must be taken into account in respect of all other assets like building, typewriter, furniture etc.

NOTE:

In examination problems depreciation is usually mentioned at certain percent per annum (% p.a.) on the cost of asset. If an asset is purchased in the current year, depreciation is to be charged for the period from the date of purchase up to the end of the year. If the almirah is purchased on 1.10.95, depreciation is to be charged for 3 months (Oct. to Dec.) on 31.12.1995. So the amount of depreciation will be Rs. 25 $\left(1000 \times \frac{10}{100} \times \frac{3}{12}\right)$. If the date of purchase is not mentioned, depreciation should be charged for 6 months, on the assumption that the asset has been purchased in the middle of the year. A note to that effect must be added.

2. SALE OF ASSETS:

Sale proceeds of assets will not be included in Income and Expenditure Account, since it is not a revenue item. But in the event of profit or loss on sale, loss will be debited to Income and Expenditure Account, but profit will not be taken to the credit of Income and Expenditure Account – it being capital income, will be credited to Capital Fund Account. If, however, the amount of profit is small, it may be credited to Income and Expenditure Account, since it will not affect the annual result in any significant manner.

3. PURCHASE AND SALE OF NEWSPAPER:

Purchase of newspaper does not result in acquisition of any asset – so it is revenue expenditure. When purchased, it is debited to Income and Expenditure Account. When old newspapers are sold, the treatment is just the reverse.

4. PURCHASE AND SALE OF SPORTS MATERIALS:

Sports materials, viz. bat, ball etc. are spoiled in a very short time – so they are treated as revenue expenditure. Their sale or purchase will be dealt with in the same manner as "Purchase and Sale of Newspaper".

5. SUBSCRIPTION:

The monthly or annual subscription paid by members is revenue income and hence credited to Income & Expenditure Account. The amount of subscription received in this year may include subscription for last year or next year, which are to be excluded. Again, current year's subscription may be accrued or it might have been received last year in advance. Since these two items of subscription relate to current year, they are to be included. Thus we see that the following four adjustments are necessary for subscription:

		With the amount of subscription received this year
1.	Last year's subscription received this year	Deduct
2.	Next year's subscription received this year	Deduct
3.	Current year's subscription received last year	Add
4.	Current year's subscription not yet received	Add

HINTS:

If the item relates to current year, add to subscription received this year; if the item does not relate to current year, deduct.

ILLUSTRATION NO. 3

From the following particulars ascertain the amount to be credited to Income and Expenditure Account in respect of subscription for the year 1995:

	Rs.
Subscription received in cash in 1995	**3,350**
Subscription for 1995 received in advance in 1994	**250**
Subscription accrued for 1994	**300**
Subscription accrued for 1995	**350**
Subscription for 1996 received in advance in 1995	**200**

Solution:

In 1995 a sum of Rs. 3,450 will be credited to Income & Expenditure Account on account of subscription. It is calculated as follows:

			Rs.
Subscription received in cash in 1995			3,350
Add	Subscription for 1995 received in 1994	250	
	Subscription for 1995 accrued	350	600
			3,950
Less	Subscription for 1994 received in 1995	300	
	Subscription for 1996 received in 1995	200	500
Total Subscription for 1995 to be credited to Income & Expenditure Account			3,450

From the above illustration it will be observed that accrued subscription for 1995 Rs. 350 is club's asset and subscription received this year in advance Rs. 200 is club's liability. The asset and liability will be shown in the Balance Sheet as follows:

BALANCE SHEET AS AT 31.12.1995

Assets	Rs.	Liabilities	Rs.
Accrued Subscription	350	Pre–received Subscription	200

6. SPECIAL SUBSCRIPTION:

Sometimes additional subscription is collected from members over and above the regular subscription for some special purposes such as construction of club's own building, charities to the poor, awarding of prizes etc. Such subscription will not be included in Income & Expenditure Account, since it is not a regular or recurring income. Such subscription is credited to Special Fund Account, viz., Building Fund Account, Charity Fund Account, Prize Fund Account etc. The amount of such fund is kept deposited

with a bank or invested in Government Papers or in gilt–edged securities. Income derived from such investment is credited to concerned Fund Account and all relative expenses are debited to the Fund Account. Such incomes–expenses will not be taken to Income & Expenditure Account. Fund is a liability – it will be shown on Liabilities side of Balance Sheet. But investment of fund money is an asset and hence it is shown on Assets side of Balance Sheet.

7. ADMISSION FEE:

At the time of admission every new member is to pay admission fee in addition to subscription. It is just like the admission fee that you pay in addition to monthly tuition fee at the time of your admission into a school or college. There is a difference of opinion among the Accountants as to whether the income on account of admission fee is to be treated as capital income or revenue income. Generally, admission fee is regarded as revenue income and credited to Income & Expenditure Account. If, however, there is any stipulation in the bye–laws of the institution, it must be observed. if it is stipulated that admission fee will be regarded as capital income, it cannot be included in Income & Expenditure Account – it will be credited to Capital Fund Account and shown on Liabilities side of Balance Sheet as an addition to that fund. Again, it may be so stipulated that admission fee is to be regarded partly as capital and partly revenue. The treatment will be clear from the following illustration.

ILLUSTRATION NO. 4

Admission fee received during 1995, Rs. 800. The bye–laws of the club provided that 40 % of admission fee is to capitalized.

Show how the above items will be treated in the Final Accounts of the club for the year-ended 31.12.1995.

Solution:

INCOME & EXPENDITURE ACCOUNT
for the year ended 31st Dec. 1995

Dr. **Cr.**

Expenditure	Rs.	Income	Rs.
		Admission Fee [60 % of 800]	480

BALANCE SHEET AS AT 31ST DEC. 1995

Assets	Rs.	Liabilities	Rs.
		Capital Fund Add Admission Fee [40 % of 800]	320

8. LEGACY:

Legacy refers to property received by virtue of a will of a person after his death. Acquisition of such property by an institution is regarded as capital receipt. Hence it will not appear in Income & Expenditure Account. Properties or cash received on account of Legacy is shown on asset side on the balance sheet on one hand and on the other hand it is added to the capital fund account on the liabilities side of the balance sheet.

9. LIFE MEMBERSHIP FEE:

In some institutions one may become a life member by paying a lump sum at a time – he is not required to pay monthly or annual subscription. So life membership fee is in effect regular subscription paid in advance. The subscriptions collected from the members are utilized for rendering services to them, so it is revenue income. But only a portion of subscription collected from life members is spent in the current year for rendering services to them. The portion which is spent in the current year, is revenue income and the unspent portion is regarded as capital income. The revenue portion is credited to Income & Expenditure Account, while the capital portion is shown in Balance Sheet on "Liabilities" side under the head "Life Membership Fee".

Suppose, life membership fee collected is Rs. 1,000, 10 % of which is to be treated as revenue. In examination problem if no direction is given, a portion of life membership fee (say 10%) should be treated as revenue adding a suitable note to that effect.

10. DONATION:

Sometimes institution like Club, Hospital etc. collect donation from members and general public. Whether such donation is to be treated as capital or revenue depends upon the purpose for which the donation is collected. If the donation is collected for any special purpose, it must be treated as capital and credited to a special fund account and shown on Liabilities side of Balance Sheet, e.g., Building Fund, Charity Fund, Prize Fund etc. On the other hand, if the donation is collected not for any special purpose, it is treated as revenue and credited to Income & Expenditure Account. But if the amount of donation is large, it is not desirable to treat it as revenue, since current year's income will be much larger than other years and the result of other years cannot be compared with that of the current year. Now the question will naturally arise as to how to judge whether the amount of donation is large or small. No clear cut direction can be given in this regard. It is to be determined on the basis of the size and position of the institution and the quantum of other items of income.

11. CAPITAL FUND:

Any concern – whether profit–seeking or non-profit-seeking – requires money for conducting day to day functions. In the case of profit-seeking concerns such money is called **Capital,** while in the case of non–profit-seeking concerns it is called **Capital Fund.** The excess of total assets over total external liabilities of a concern is called Capital Fund. Capital Fund is created with surplus revenue and capital receipts and incomes, such as surplus (excess of income over expenditure). Donation, Life Membership Fee, Admission Fee, Profit on Sale of Fixed Assets etc. It is also called **General Fund or Accumulated Fund**

or surplus Account. It is shown on Liabilities side of Balance Sheet as the first item. In practice, Capital Fund is the capital of a non profit-seeking concern.

METHOD OF CONVERSION OF RECEIPTS AND PAYMENTS ACCOUNT INTO INCOME AND EXPENDITURE ACCOUNT

At first, Receipts and Payments Account is prepared by analyzing the Cash Book — subsequently, Income and Expenditure Account is prepared in the following manner:

1. Exclude the opening and closing balances of Receipts and Payments Account.
2. Exclude all the capital items.
3. Exclude all revenue items relating to last or next year.
4. Include all items of income or expenditure relating to the current year, if they are not received or paid in the current year.
5. Charge depreciation on all wasting assets.

HINTS:

While preparing Income and Expenditure Account from Receipts and Payments Account apply the following two rules;

1. Exclude all capital items.
2. Adjust all revenue items with outstanding and advance items in the following manner:
   (i) If relates to current year: Add
   (ii) If relates to last or next year: Deduct.

DISTINCTION BETWEEN RECEIPTS AND PAYMENTS ACCOUNT AND INCOME AND EXPENDITURE ACCOUNT

Non–profit–seeking institutions repair the above two accounts and submit them at the annual general meeting for the information of the members. There are sharp differences between the two accounts. In general Receipts and Payments Account may be called abridged Cash Book — all the cash transactions of the whole year are recorded in it in a summarized form. On the other hand, the Income and Expenditure Account may be compared with the Profit and Loss Account of a business concern. These two accounts are prepared on the same lines.

The points of distinction between Receipts and Payments Account and Income and Expenditure Account are given below in Tabular form:

	Receipts & Payments Account		Income & Expenditure Account
1.	It is a summarized statement of all cash transactions during an accounting year.	1.	It is the account of revenue income and revenue expenditure of an accounting year.

2.	Only cash transactions are recorded here.	2.	It is not confined to cash transactions only, i.e. non–cash transactions are also included in it.
3.	The portion of income or expenditure which has been received or paid in cash this year, is recorded here.	3.	The whole amount of income or expenditure—whether received or paid in cash or not—is recorded in it.
4.	Transactions involving cash receipts are recorded on Debit side and those involving cash payments are recorded on Credit side.	4.	All expenditures are recorded on Debit side and all incomes on Credit side.
5.	Transactions—both capital and revenue—are recorded here.	5.	Only revenue transactions are recorded here.
6.	Its balance can never be credit.	6.	Its balance may be either debit or credit.
7.	Its balance is carried over to Receipts & Payments Account of the next year.	7.	Its balance is transferred to Capital Fund.
8.	This account shows opening balance except in the first year.	8.	It has no opening balance.
9.	The closing balance of this account represent in the first year.	9.	Its closing balance represents either surplus or deficit. Credit balance indicates surplus, while debit balance indicates deficit.
10.	This account records transactions relating to past, present and future years. Hence, no adjustment is made for pre–received or accrued incomes and pre–paid or outstanding expenses. In a word, it is prepared on cash basis.	10.	Transactions relating to the current year only are recorded in it. Hence, adjustments are invariably made for pre–received or accrued incomes and pre–paid or outstanding expenses. In a word, it is prepared on Accrual basis.*
11.	It is, in fact, an abridged Cash Book.	11.	It is, infect, similar to Profit & Loss Account of a profit–seeking business concern.
12.	It is outside the Double Entry system.	12.	It is within the Double Entry system.
13.	It is not accompanied by Balance Sheet.	13.	It is accompanied by Balance Sheet.
14.	Its preparation is not compulsory.	14.	It is compulsory. It must be prepared in order to ascertain the true result of a concern.

ILLUSTRATION NO. 5

The following is the Receipts & Payments Account of a club for the year ended 31.12.91.

Dr. **RECEIPTS AND PAYMENTS ACCOUNT** **Cr.**

Receipts	Rs.	Payments	Rs.
Balance b/d	5,000	Sports Equipments	7,000
Subscription:		Salaries & Wages	3,000
1990	2,000	Office Expenses	400
1991	10,000	Electric Charges	600
Donation	1,000	Telephone Charges	600
Entrance Fees	2,000	Balance c/d	8,400
(to be capitalized)			
	20,000		20,000

(a) In 1990 subscription for 1991 was received Rs. 1,000.

(b) Outstanding subscription Rs. 1,500.

(c) Outstanding salaries & wages Rs. 1,000.

(d) Depreciation to be charged @ 20 % on sports equipments.

Prepare from the above particulars the Income & Expenditure Account of the club.

Solution:

INCOME AND EXPENDITURE ACCOUNT
for the year ended 31.12.1991

Dr. **Cr.**

Expenditure		Rs.	Income		Rs.
Salaries & Wages	3,000		Subscription	10,000	10,000
Add Outstanding	1,000	4,000	Add Received in 1990	1,000	1,000
Office Expenses		400	Add Accrued	1,500	12,500
Electric Charges		600	Donation		
Telephone Charges		600			
Depreciation on Sports Equipments [20 % of 7,000]		1,400			
Surplus i.e. Excess of Income over Expenditure		6,500			
		13,500			13,500

NOTE: Rate of depreciation on sports equipments is 20 % (not 20 % p.a.). So the amount of depreciation will be Rs. 1,400 (20 % of 7,000) . The date of purchase is immaterial here.

ILLUSTRATION NO. 6

From the following Receipts and Payments Account of Nice Club during the year 1995 and further particulars given below prepare an Income and Expenditure Account of the club for the year ended 31st December, 1995 and also a Balance Sheet as on that date.

RECEIPTS AND PAYMENTS ACCOUNT
for the year ended at 31st December, 1995

Dr. Cr.

Receipts	Rs.	Payments		Rs.
Subscription	5,200	Salaries		1,400
Donation	300	Rent		1,300
Admission Fees	100	Printing and Stationery		100
Sale of old newspapers	60	Postage		80
		Newspapers		70
		Furniture		1,000
		Balance c/d		
		Cash	150	
		Bank	1,560	1,710
	5,660			5,660

Subscription includes Rs. 250 collected in advance for the year 1996. A sum of Rs. 400 is due by members on account of subscription on 31.12.1995. The following expenses are outstanding on 31.12.1995 — salaries Rs. 300 and rent Rs. 200.

Solution:

NICE CLUB
Income and Expenditure Account
for the year ended 31st December, 1995

Dr. Cr.

Expenditure		Rs.	Income		Rs.
Salaries	1,400		Subscription	5,200	
Add Outstanding	300	1,700	Add Accrued	400	
Rent	1,300			5,600	
Add Outstanding	200	1,500	Less Received for 1996	250	5,350
Printing & Stationery		100	Donation		300
Postage		80	Admission Fees		100
Newspapers		70	Sale of old newspapers		60
Excess of Income over Expenditure		2,360			
		5,810			5,810

BALANCE SHEET AS AT 31ST DECEMBER , 1995

Assets	Rs.	Liabilities	Rs.
Furniture	1,000	Capital Fund	2,360
Bank	1,560	[Excess of income over	
Cash	150	expenditure	
Subscription Accrued	400	Pre–received Subscription	250
		Salaries Outstanding	300
		Rent Outstanding	200
	3,110		3,110

NOTE: In the absence of rate, depreciation on furniture has not been taken into account.

ILLUSTRATION NO. 7

The following is the position of the Lahore Library as at 1st January, 1995.

Assets	Rs.	Liabilities	Rs.
Building	**50,000**	**Capital Fund**	**1,50,000**
Furniture	**5,000**	**Outstanding Liabilities for**	
Library Books	**25,000**	**Expenses**	**5,000**
Investment	**50,000**		
Accrued Subscription	**20,000**		
Cash	**5,000**		
	1,55,000		**1,55,000**

An analysis of the Cash Book during the year gives the following particulars:

Receipts	Rs.	Payments	Rs.
Subscription	**75,000**	**Salaries**	**3,600**
Donation	**50,000**	**Purchase of Books**	**40,000**
Interest on Investment	**600**	**Rent & Taxes**	**3,600**
Sale of old Furniture	**500**	**Outstanding Liabilities**	**5,000**
Proceeds from Lectures	**8,000**	**Insurance Premium**	**1,500**
		Printing & Stationery	**450**
		Sundry Expenses	**450**
		Purchase of Furniture	**7,500**
		Investment	**75,000**
		Balance c/d	**2,000**

The following adjustments are required:

(a) **Accrued subscription amounts to Rs. 15,000.**

(b) **Outstanding liabilities for expenses Rs. 7,500.**

(c) **Insurance premium amounting to Rs. 300 was paid in advance.**

(d) **Depreciate building at 5 %, library books at 10 % and investment by 5 %, such depreciation to be calculated on the opening balances of the assets in question.**

Prepare Income and Expenditure Account for the year ended 31st December, 1995 and a Balance Sheet as at that date.

Solution:

THE LAHORE LIBRARY
Income and Expenditure Account
for the year ended 31st December, 1995

Dr. Cr.

Expenditure		Rs.	Income		Rs.
Salaries		3,600	Subscription	75,000	
Rent and Taxes		3,600	Add Accrued	15,000	
Insurance Premium	1,500			90,000	
Less Prepaid	300	1,200	Less Arrear	20,000	70,000
Printing & Stationery		450	Interest on Investment		600
Sundry Expenses		450	Proceeds from Lectures		8,000
Outstanding Liabilities for Expenses		7,500			
Depreciation on:					
Building	[5 % 50,000]	2,500			
Library Books	[10 % 25,000]	2,500			
Investment	[5 % 50,000]	2,500			
Excess of Income over Expenditure		54,300			
		78,600			78,600

BALANCE SHEET AS AT 31ST DECEMBER, 1995

Assets		Rs.	Liabilities		Rs.
Building	50,000		Capital Fund	1,50,000	
Less Depreciation @ 5 %	2,500	47,500	Add Donation	50,000	
Furniture	5,000		Surplus	54,300	2,54,300
Add Purchases	7,500		Outstanding Liabilities		
	12,500		for Expenses		7,500
Less Sales	500	12,000			
Library Books	25,000				
Add Purchases	40,000				
	65,000				
Less Depreciation @ 10%	2,500	62,500			
Investment	50,000				
Add Purchases	75,000				
	1,25,000				
Less depreciation					
@ 5%	2,500	1,22,500			
Prepaid Insurance		300			
Accrued Subscription		15,000			
Cash in hand		2,000			
		2,61,800			2,61,800

NOTE:

The amount of donation being large, it has been treated as capital item.

ILLUSTRATION NO. 8

From the following Receipts and Payments Account of the Crown Club prepare an Income and Expenditure Account for the year ended 31st December, 1995 and a Balance Sheet as on that date.

RECEIPTS AND PAYMENTS ACCOUNT
for the year ended 31st December 1995

Dr. Cr.

Receipts	Rs.	Payments	Rs.
Balance b/d	130	Rates	2,500
Entrance Fees	210	Stationary	340
Subscription		General Expenses	3,610
1994	70	Capital Expenditure	2,500
1995	10,520	Repairs	300
1996	420	Mortgage Interest	1,600
Locker Rent	300	Balance c/d	2,460
Miscellaneous	1,660		
	13,310		13,310

The following further information is available:

1. Locker rent Rs. 20 referred to the previous year and Rs. 30 is still owing.
2. Rates Rs. 620 referred to the previous year and Rs. 620 is still owing.
3. Subscription unpaid for the current year Rs. 210.
4. The capital expenditure of building up to 31st December, 1994 was Rs. 67,500 on which there was a mortgage of Rs. 40,000 at 6 % p.a.
5. Depreciation is to be provided on building including additions at 5 %.

Solution:

THE CROWN CLUB
Income and Expenditure Account
for the year ended 31st December, 1995

Dr. Cr.

Expenditure		Rs.	Income		Rs.
Rates		2,500	Subscription		10,520
Add Outstanding	620		Add Accrued	210	10,730
	3,120		Entrance Fees		210
Less Paid for 1994	620	2,500	Locker Rent	300	
Stationery		340	Add Accrued	30	
General Expenses		3,610		330	
Repairs		300	Less Received for 1994	20	310
Mortgage Interest	1,600		Miscellaneous fees		1,660
Add Outstanding	800	2,400			
Depreciation on Building 5 % [67,500 + 2,500]		3,500			
Excess of Income over Expenditure		260			
		12,910			12,910

BALANCE SHEET AS AT 31ST DECEMBER, 1994

Assets	Rs.	Liabilities	Rs.
Building	67,500	Capital Fund	27,100
Cash in hand	130	(balancing figure)	
Locker Rent Accrued	20	Mortgage	40,000
Subscription Accrued	70	Rates Outstanding	620
	67,720		67,720

BALANCE SHEET AS ON 31ST DECEMBER 1995

Assets		Rs.	Liabilities		Rs.
Building	67,500		Capital Fund	27,100	
Addition during the year	2,500		Add Surplus	260	27,360
	70,000		Mortgage	40,000	
Less Depreciation @ 5%	3,500	66,500	Add Interest		
Cash in hand		2,460	Outstanding	800	40,800
Locker Rent Accrued		30	Pre–received Subscription		420
Subscription Accrued		210	Rates Outstanding		620
		69,200			69,200

NOTES:

(1) Capital Fund is obtained by deducting liabilities from assets. Opening Capital Fund has been determined through last year's Balance Sheet by this rule.

(2) Total interest on mortgage @ 6 % p.a. comes to Rs. 2,400 $\left(40{,}000 \times \frac{6}{100}\right)$. But interest actually paid is Rs. 1,600. Therefore, interest outstanding is Rs. 800(2,400 – 1,600). It may be shown in Balance Sheet as a separate item, instead of adding it to mortgage.

ILLUSTRATION NO. 9

Preparation of a receipts and payments account, income and expenditure account and balance sheet.

From the following particulars of Punjab Literary Society, prepare Receipts and Payments account and Income and Expenditure account for the year ended December 31, 1995 and a Balance Sheet as on that date:

BALANCE SHEET
As on December 31, 1994

Assets	Rs.	Liabilities	Rs.
Cash at Bank	36,000	O/S Creditors for expenses	5100
Investments	40,000	Reserve Fund	6900
Library Books	92,000	Capital Fund	180,000
Furniture	17,700		
O/S Subscription	4800		
Accrued interest	1500		
	192,000		192,000

The transaction for the year 1995.

RECEIPTS:

Subscription Rs. 30,000; Proceeds from entertainment and lectures Rs. 12,000; Interest on Investments Rs. 5700; Entrance fees Rs. 6000; Sales proceeds of old furniture Rs. 900 (Book value Rs. 1200).

PAYMENTS:

Salaries and wages Rs. 12,000; Rent Rs. 7200; Cost of entertainment Rs. 9000; Printing Charges Rs. 1800; Miscellaneous expenses Rs. 660; Advertising Rs. 1400; Purchase of investments Rs. 10,000; Purchase of furniture Rs. 7200; Purchase of library books Rs. 11,600; Binding charges Rs. 1000; Outstanding creditors Rs. 5100.

Adjustments on December 31, 1995

(a) Outstanding subscription Rs. 3900 and accrued interest on investments Rs. 1800.

(b) Outstanding liabilities for; Rent Rs. 1200, Printing Rs. 900 and Audit fees Rs. 1000.

(c) Subscription received in advance for 1996 Rs. 1200.

(d) Provide depreciation on library books at 10 per cent and on furniture at 6 per cent. (The additions to library books and furniture were made in the middle of the year and the old furniture was sold at the beginning of the year).

(e) The by–laws of the Society provide that 50 per cent of the Entrance fees and 10 per cent of the surplus of any year are to be transferred to the Reserve Fund.

Solution:

In the Books of Punjab Literary Society
Receipts and Payments A/c
For the year ended 31.12.1995

Dr.	Rs.		Cr. Rs.
Balance b/d	36,000	Salaries	12,000
Subscriptions	30,000	Rent	7200
Receipts from Lecture	12,000	Entertainment Exp.	9000
Interest on Investment	5700	Printing Charges	1800
Entrance Fees	6000	Misc. Expenses	660
Sale proceeds of Furniture	900	Advertising Expenses	1400
		Investment Purchased	10,000
		Furniture Purchased	7200
		Binding Charges	1000
		Outstanding Creditors	5100
		Library Books	11,600
		Balance c/d	23640
	90,600		90,600

Income and Expenditure A/c
For the year ended 31.12.1995

Dr.	Rs.		Cr. Rs.
Salaries	12,000	Subscriptions	27,900
Rent	8400	Receipts of Lectures	12,000
Entertainment Exp.	9000	Int. on Investment	6000
Printing Charges	2700	Entrance Fees	3000
Misc. Expenses	660		
Advertising	1400		
Binding Exp.	1000		
Outstanding Audit Fees	1000		
Loss on sale of Furniture	300		
Depreciation	10,986		
Surplus transferred to Reserve Fund	145		
Excess of Income over Expenditure	1309		
	48,900		48,900

BALANCE SHEET
AS ON 31.12.1995

Assets	Rs.	Liabilities		Rs.
Cash at Bank	23,640	Capital Fund	180,000	
Investments	50,000	+ Income and		
		Exp. A/c. bal.	1309	181309
Library Books	93,820	Reserve Fund	6900	
Furniture	22,494	+ Entrance fees	3000	
O/S Subscription	3900	+ 1/10 of surplus	145	10,045
Accrued Interest	1800	Outstanding Expenses:		
		Rent	1200	
		+ Printing Charges	900	
		+ Audit fees	1000	3100
		Subscription in Advance		1200
	195,654			195,654

WORKING NOTES:

1. **FURNITURE A/C**

Dr.	Rs.		Cr. Rs.
Balance b/d	17,700	Bank	900
Bank	7200	Income Expend. (loss)	300
		Depreciation	1206
		Balance c/d	22,494
	24,900		24,900

2. **SUBSCRIPTION A/C**

Dr.	Rs.		Cr. Rs.
O/S Subscription	4800	Bank	30,000
Income and Expenditure	27,900	O/S Subscription	3900
Subscription in Advance	1200		
	33,900		33,900

INTEREST ON INVESTMENT A/C

Dr.	Rs.		Cr. Rs.
Accrued Interest	1500	Bank	5700
Income and Expenditure	6000	Accrued Interest	1800
	7500		7500

ILLUSTRATION NO. 10

As on March 31, 1996 the following balance have been extracted from the books of accounts of Ravi Recreation Club and you are asked to prepare:

(i) The Income and Expenditure account for the year ended March 31, 1996, and

(ii) A Balance Sheet as on that date after incorporation of proper adjustments for the following:

Stock as on 31.03.1996

	Rs.
Bar	900
Diming room	60

Provide depreciation as under

	Rs.
On fixtures and fittings	60
On billiard table	390
On Furniture	560

DEBIT BALANCE	
Stock of bar on 1.4.1995	90
Stock on dining room on 1.4.1995	1080
Purchases for bar	24,660
Purchases for dining room	32,370
Rent 10,470	
Wages	18,690
Repairs and renewals of china, glass and linen	5400
Fuel and light	5280
Miscellaneous expenses	4050
Cash in hand	560
Cash at bank	2760
Fixed deposit with bank	8500
Sundry debtors	2250

China, glass, cutlery and linen	600
Billiard table	2070
Fixtures and fittings	870
Furniture	4140
Club premises	30,000
	153,840

CREDIT BALANCES

	Rs.
Takings – Bar	39,150
Takings — Dining room	48,510
Subscriptions	9450
Billiard's receipts	7300
Sundry receipts	410
Interest on fixed deposit with bank	270
Sundry creditors	5370
Capital Fund	42,000
Surplus on 1.04.1995	1380
	153,840

Solution:

RAVI RECREATIONS CLUB
Income & Expenditures Account
For the year Ending 31.3.1996

Expenditures		Rs.	Income		Rs.
Opening Stock:			Takings:		
Bar	90		Bar	39150	
Dining	1080	1170	Dining	48510	87660
Purchases:			Stocks:		
Bar	24660		Bar	900	
Dining	32370	57030	Dining	60	960
Wages		18690	Subscriptions		9450
Rent		10470	Billiards Receipts		7300
Repairs		5400	Sundry Receipts		410
Fuel & Light		5280	Interest on Fixed deposit		270
Misc. Expenses		4050			
Depreciation (total)		1010			
Surplus		2950			
		106050			106050

BALANCE SHEET
As on 31.03.1996

Assets		Rs.	Fund and Liabilities		Rs.
Cash in hand		560	Capital Fund		42,000
Cash at bank		2760	Surplus	1380	
Fixed deposit with bank		8500	+ during the year	2950	4330
Debtors		225	Creditors		5370
China glass cutlery		600			
Billiard table		1680			
Fixtures		810			
Furniture		3580			
Club premises		30,000			
Closing stock					
Bar	900				
Dining room	60	960			
		51,700			51,700

ILLUSTRATION NO. 11

Preparation of income and expenditure account and balance sheet.

The following is the Receipts and Payments account of the Multan Literary Society for the year ended March 31. 1995.

Receipts	Rs.	Payments	Rs.
Cash at bank	**12,500**	**Salaries**	**2500**
Subscriptions	**52,500**	**Printing and stationery**	**1250**
Annual Day receipts	**26,800**	**Annual Day expenses**	**21,500**
Mushaira receipts			
(poetic symposium)	**22,500**	**Musharia expenses**	**10,000**
Dividend on share	**2500**	**Telephone charges**	**2500**
		Sundry expenses	**2000**
		Shares purchased	**55,000**
		Postage and Telegrams	**2200**
		Building & Maintenance	**6340**
		Cash at Bank	**13,510**
	116,800		**116,800**

Other Information:

1. The value of the building owned by the society stood at Rs. 50,000 as on April 1, 1994. Depreciation at 5 % has to be provided.
2. There were 200 members paying a subscription at the rate of Rs. 250 per annum each.
3. As on April 1, 1994 no subscription has been received in advance, but subscriptions were outstanding to the extent of Rs. 1000. As on March 31, subscriptions outstanding were Rs. 1500.
4. Postage stamps worth Rs. 250 were with the secretary at the beginning of the year and the stamps at the end of the year were of the value Rs. 150.
5. The investment in shares at the beginning of the year was to the extent of Rs. 5000.
6. An amount of Rs. 250 in respect of the Annual Day receipts was yet to be received.
7. The rent of the theatre (amounting to Rs. 2,500) where the Mushaira was held is still to be paid.
8. Hire of telephone to the extent of Rs. 300 is paid in advance.

You are required to prepare the Income and Expenditure account for the year ended March 31, 1995 and the Balance Sheet as on that date.

Solution:

MULTAN LITERARY SOCIETY
Income & Expenditure Account
For the year ended 31.3.95

Dr. Expenditure	Rs.	Income	Cr. Rs.
Salaries	2500	Subscription	50,000
Printing and Stationery	1250	Surplus on Mushaira	10,000
Telephone Charges	2200	Surplus on Annual day	5550
Sundry Exp.	2000	Dividend on Shares	2500
Postage and Telegrams	2300		
Building Maintenances	6340		
Depreciation on Building	2500		
Excess of Income over expenditure	48,960		
	68,050		68,050

Balance Sheet
As on 31.03.1995

Assets		Rs.	Liabilities		Rs.
Building	50,000		Capital Fund		
–Depreciation	500	47,500	Opening Balance	68,750	
			+ Surplus	48,960	117,710
Investment in shares		60,000	Rent Payable		2500
Cash at Bank		13,510	Subscription received in		
O/S Subscription		1500	advance		3000
Postal Stamps on hand		150			
Prepaid Telephone Charges		300			
Annual day receivables		250			
		123,210			123,210

WORKING NOTES:

1. **ANNUAL DAY COLLECTION**

Dr.	Rs.		Cr. Rs.
Income and Expend A/c	27,050	Bank	26,800
		Amounts receivable	250
	27,050		27,050

2. **SUBSCRIPTION (CONSOLIDATED) A/C**

Dr.	Rs.		Cr. Rs.
O/s Subscription 1.4.1994	1000	Bank	52,500
Income and Expend A/c	50,000	O/s Subscription	1500
Subscription in Advance	3000		
	54,000		54,000

3. **OPENING BALANCE SHEETS AS ON 1.04.1994**

Assets	Rs.	Funds and Liabilities	Rs.
Building	50,000	Capital Fund	68,750
Cash at Bank	12,500		
Investment in shares	5000		
O/S Subscription	1000		
Postal Stamps on hand	250		
	68,750		68,750

MUSHAIRA EXPENSES

Dr.			Cr.
	Rs.		Rs.
Bank	10,000	Income & Expenditure	12,500
Rent Payable	2500		
	12,500		12,500

TELEPHONE CHARGES

Dr.			Cr.
	Rs.		Rs.
Bank	2500	Prepaid Expenses	300
		Income and Expend A/c	2200
	2500		2500

POSTAGE AND TELEGRAM A/C

Dr.			Cr.
	Rs.		Rs.
Stamps on hand 1.4.94	250	Income and Expenditure	2300
Bank	2200	Stamps on hand	150
	2450		2450

ILLUSTRATION NO. 12

Receipts and Payments Account for the year ended 31st December, 1994 of Gujranwala Sport Clubs given below:

Dr. *Cr.*

Receipts		Rs.	Payments	Rs.
1994, Jan 1			1994 Dec. 31	
Balance b/d		1,500	Salaries	3,600
1994 Dec. 31			Stationery	400
Subscriptions:			Taxes	600
1993	100		Telephone	300
1994	4,800		Investment in Govt. Bonds	1,500
1995	200	5,100	Sports expenses	1,150
Receipts from sports		1,200	Miscellaneous expenses	800
Sale of car		300	Balance c/d	1,150
Interest on Investments		1,400		
		9,500		9,500

Additional Information:

(1) Subscriptions yet to be received for the year 1994: Rs. 360.

(2) Stationery closing stock 1993 Dec. 31st: Rs. 250 and on Dec. 31st 1994: Rs. 190.

(3) Taxes paid up to 31st March 1995.

(4) Telephone expenses yet to paid Rs. 75.

(5) On 31st Dec. 1993 miscellaneous expenses unpaid were Rs. 100.

(6) On 31st Dec. 1993 Buildings were Rs. 20,000; Investments Rs. 18,500, Motor car Rs. 500.

Buildings are to be depreciated at 5 per cent.

Prepare income and expenditure account and Balance Sheet for the year 1994.

Solution:

Income and Expenditure Account of Gujranwala Sports Club for the year ended 31st December, 1994

Dr.		Rs.	Cr.		Rs.
Salaries		3,600	Subscriptions	4,800	
Stationery	400		Add: Receivable	360	5,160
+ op. Balance	250				
	650				
Less: Closing Balance	190	460	Receipts from sports		1,200
Taxes	600		Interest on investment		1,400
Less: Prepaid	150	450	Excess of expenditure		
Telephone	300		over income		175
Add: Outstanding	75	375			
Sports expenses		11,150			
Miscellaneous					
expenses paid	800				
Less: Last year's	100	700			
Loss on sale of car		200			
Depreciation on Buildings		1,000			
		7,935			7,935

(OPENING) BALANCE SHEET AS ON 1.1.1994

Assets	Rs.	Liabilities	Rs.
Cash	1,500	Outstanding Miscellaneous expenses	100
Buildings	20,000	Capital Fund (Bal. Fig.)	40,750
Investments	18,500		
Motor Car	500		
Subscriptions receivable	100		
Stock of stationary	250		
	40,850		40,850

BALANCE SHEET AS ON 31.12.1994

Assets		Rs.	Liabilities		Rs.
Buildings	20,000		Capital Fund	40,750	
Less: depreciation	1,000	19,000	Less: Excess of		
Cash		1,150	expenditure		
Investment	18,500		over income	175	40,575
Add: Additions	1,500	20,000	Subscriptions received		
Subscriptions receivable		360	in advance		200
Stock of stationary		190	Outstanding Telephone		
Prepaid taxes		150	charges		75
		40,850			40,850

QUESTIONS

1. What is meant by non–profit making concerns?
2. What is "Receipts & payments" account? It is prepared by whom and what purpose it serves?
3. What is "Income and expenditure" account? Who prepares it and why?
4. What is the difference between a "Receipts & Payments Account" and an "Income & Expenditure Account"? What steps are required for converting (a) Receipts & Payments Account into Income and Expenditure Account and (b) Income & Expenditure Account into Receipts & Payments Account.
5. In each of the following cases, indicate the alternative which you consider to be correct:-

(a) Non–trading institutions prepare —
- (i) income and expenditure account
- (ii) trading and profit and loss account
- (iii) manufacturing account

(b) receipts and payment accounts shows —
- (i) income and expenditure
- (ii) Dr. and Cr. balances of ledger account
- (iii) cash excepts and payments

(c) Receipt and payment account shows —
- (i) opening and closing cash balances
- (ii) income and expenditure
- (iii) assets and liabilities

(d) Income and expenditure account reveals —
- (i) cash in hand
- (ii) excess of revenue over expenditure or excess of expenditure over revenue
- (iii) capital account

(e) Income and expenditure account records transactions of —
- (i) revenue nature only
- (ii) capital nature only
- (iii) both revenue and capital nature
- (iv) income of revenue nature and expenditure of revenue and capital nature

(f) Subscriptions received in advance is —
- (i) an income
- (ii) an asset
- (iii) a liability

(g) Subscriptions in arrears are shown on the —

(i) credit side of income and expenditure account and assets side of balance sheet

(ii) debit side of income and expenditure account and liabilities side of a balance sheet

(iii) only on the assets side of a balance sheet

(h) Donations received for a special purpose —

(i) should be credited to a separate account and shown in the balance sheet

(ii) should be credited to income and expenditure account

(iii) should not be recorded at all

(i) Income against service which has to be rendered for a long time without further payment —

(i) credited to the income and expenditure account

(ii) added directly to the general or capital fund

(iii) debited to the income and expenditure account

(j) The income through admission fee should be —

(i) capitalized

(ii) treated as revenue

(iii) treated as revenue unless the amount is pretty large

(iv) treated as liability

(k) If there is a tournament fund, then tournament expenses and incomes are transferred to —

(i) income and expenditure account

(ii) asset side of the balance sheet

(iii) the liability side of the balance sheet

(iv) both income and expenditure account and to balance sheet.

Ans: *[(a) (i); (b) (iii); (c) (i); (d) (ii); (e) (i); (f) (iii); (g) (i); (h) (i); (i) (ii); (j) (i); (k) (iii)]*

6. Explain the meaning of the following terms. How you will deal with each of these while preparing income and expenditure account?

(a) Legacies

(b) Donation for specific purposes

(c) Donations (purpose is not given)

(d) Life membership fees

(e) Entrance fees

(f) Endowment fund receipts

(g) Receipts for tournament fund.

PROBLEMS

1. The following is the Receipts and Payments Account of Young men's Society for the year ending 31st December, 1994. You are required to prepare Income and Expenditure Account for the year ending 31st December, 1994 and Balance Sheet as on that date.

RECEIPTS AND PAYMENTS ACCOUNT

Receipts	*Rs.*	*Payments*	*Rs.*
Balance 1.1.1994	3,485	Books	6,150
Entrance fees	650	Printing and stationery	465
Donations	6,000	Newspapers	1,110
Subscriptions	8,565	Sports Material of Purchased	5000
Interest on investments	200	Repairs	650
Sale of furniture	685	Investments	2,000
Sale of old papers	465	Furniture	1,000
Receipts from recreations	865	Salaries	1,500
Miscellaneous receipts	125	Balance 31.2.1994	3,165
	21,040		21,040

Capitalize entrance fees and Donations. Sports Material valued on 31.12.1994 at Rs. 4,000.

Ans: *[Surplus : Rs. 5180 : B/s Rs. 15315].*

2. From the particulars given below prepare the Income and Expenditure Account and the Balance sheet of a Music Club started on 1.4.1993 for the year ended on 31st March 1994:

Receipts	*Rs*	*Payments*	*Rs.*
Life Member's fees	8,000	Land and Buildings	20,000
Donations	12,000	Concert Expenses	10,000
Entrance fees	6,000	Furniture	2,500
Subscriptions	6,000	Purchase of public address system	4,000
Interest on securities	400	Salaries	800
Rent on a part of the		Printing and Stationery	600
Building let out	6,000	Telephone expenses	300
Annual grant from the		Investments	3,000
State Government	9,600	Annual award for the	
		Musician of the year	3,800
		Cash in hand	1,000
		Cash at bank	2,000
	48,000		48,000

One–third of the entrance fees received was to be credited to revenue and Donations and Life Member's Fees are to be capitalized. Interest on securities due but not received amount to Rs. 100. Depreciate Land and Buildings, furniture by 5 % and Public Address system by 2 % outstanding subscriptions for the year 1993 – 1994 are Rs. 200 and advance receipt of subscriptions on account of the year 1994 – 1995 is Rs. 400. Salaries unpaid for the year 1993 – 1994 amount to Rs. 125.

Ans: *[Surplus: Rs. 7070 : B/s 31595]*

3. Below is given the Receipts and Payments Account of Leo's Club. Lahore, Prepare Income and Expenditure Account as on 31st December 1991 and a Balance sheet as on that date, from it and subjoined information.

	Rs		*Rs.*
Balance b/d	2,476	General Expenses	1,084
Annual Subscription	3,260	Salaries	1,100
Life Membership fees	500	Furniture	1,600
Entrance fees	400	Rent	1,120
Miscellaneous Receipts	466	Printing	250
Interest	80	Repairs	300
		Balance c/d	1,728
	7,182		7,182

On 31 December, 1991 the annual subscriptions in arrears amounted to Rs. 700. Rs. 200 is to be written off as depreciation on furniture.

Ans: *[Surplus: Rs. 852: B/s Rs. 3828]*

4. The following particulars are obtained from the books of Young men's Association, for the year ended December 31, 1990.

Receipts and Payments Account for the year ended December 31, 1990.

Receipts		*Rs*	*Payments*	*Rs.*
Balance b/d		7,000	Salaries	3,000
Subscriptions:			Printing & Stationery	300
1989	500		Postage & Telephone	1,800
1990	9,000		Municipal taxes	1,600
1991	1,000	10,500	Cutlery purchases	3,000
Entrance fees		1,000	Electricity Charges	1,200
Life Membership		5,000	Annual Dinner charges	4,800
Annual Dinner		6,000	Fixed deposit with ABL Bank	12,000
Hall Rent		3,000	Balance c/d	5,400
Miscellaneous Income		600		
		33,100		33,100

On 1 January, 1990 the Association had a building worth Rs. 2,00,000, cutlery worth Rs. 6,000 and kitchenware worth Rs. 8,000. There is a deposit with the Telephones Department under the "Own Your Telephone Scheme" amounting to Rs. 8,000. Entrance Fees and Life Membership Fees are to be capitalized.

You are required to depreciate building by 5 %, cutlery by 40 % and kitchenware by 25 %. The Annual Subscription of the Association Members is Rs. 10, and 100 members are in arears during this year.

Municipal taxes were paid up to March 31, 1991.

You are required to prepare an Income and Expenditure Account for the year ended December 31, 1990 and a Balance Sheet as on that date, after making the necessary adjustments.

Ans: *[Deficit: Rs. 7100: B/s Rs. 229400]*

5. The following is the Receipts and Payments Account of a Sports Club for the year ended 31st December, 1994.

RECEIPTS AND PAYMENTS ACCOUNT

Dr.			*Cr.*
Balance 1st Jan. 1994	2,800	Secretary's Salary	3,600
Entrance fee	500	Upkeep of grounds (c)	2,200
Subscriptions (a)	8,700	Wages to ground men (d)	2,500
Proceeds of concerts	1,500	Ground rent	200
Interest of investment (b)	500	Printing and Postage	200
		Sundry repairs	200
		Balance on 31st Dec. 1994	5,100
	14,000		14,000

(a) This item includes subscriptions outstanding brought over from previous year Rs. 400.

(b) This item includes Rs. 100 in respect of interest accrued in the proceeding period.

(c) This item includes Rs. 200 applicable to the previous year.

(d) This item includes Rs. 100 applicable to the previous year.

Other ledger balances at the commencement of the accounting period were: capital fund Rs. 40,500, Income and Expenditure Account credit balance brought forward, Rs. 8,900, Club premises and grounds Rs. 30,000, Investments Rs. 10,000, Sports equipment Rs. 2,400, Furniture and fixtures Rs. 4,000.

Entrance fees are to be capitalized. The outstanding liabilities on 31st December, 1994 were: Wages Rs. 200, Sundry repairs Rs. 50, Interest accrued and Outstanding on Investment was Rs. 150. Depreciate furniture by 5 % and sports equipment by 10 per cent.

From the above particulars prepare a Balance sheet at the commencement of the period and Income and Expenditure Account for the year ended 31st December 1994, and a Balance sheet as on the same date.

Ans: *[Surplus: Rs. 1060: B/s Rs. 51210]*

6. The following was the Receipts and Payments Account of Model Town Literary Society for the year ending 31st December, 1994.

RECEIPTS AND PAYMENTS ACCOUNT

	Rs		*Rs.*
Balance b/d	500	Rent and Taxes	1,000
Entrance fees	1,500	Wages	500
Subscriptions	10,000	Lighting charges	250
Life member's fees	500	Lectures, fees	1,000
Donations	3,500	Books	1,500
Interest on Investments	100	Office Expenses	2,000
Receipts from lectures	3,000	Fixed deposits	10,000
		(on 1.7.94 @ 10 %)	
		Furniture	2,000
		Cash in hand	50
		Cash at bank	800
	19,100		19,100

At the beginning of the year Society had the following assets: Books Rs. 4,000; Furniture Rs. 1,000; Investments, Rs. 1,000.

Subscriptions receivable at the beginning of the year was Rs. 1,000, at the end of the year is Rs. 500. Rent was outstanding for six months (Rs. 500) both at the beginning and at the end of the year. Capitalize entrance fees and life members' fees. Depreciate Rs. 300 on furniture, and Rs. 100 on books. Interest on fixed deposit was not yet received. You are required to prepare Income and Expenditure Account for the year ending 31st December 1994 and a Balance Sheet as on that date.

Ans: *[Surplus: Rs. 7950: B/s Rs. 20950]*

7. Given below is the Receipts and Payments Account of the Eagle Club for the year ending 31st December 1994:

	Rs		Rs.
Balance B/d	10,250	Salaries	6,000
Subscriptions:		General expenses	750
1993	400	Drama expenses	4,500
1994	20,500	News–papers etc.,	1,500
1995	600	Municipal taxes	400
Donations	5,400	Charity	3,500
Proceeds of Drama tickets	9,500	Investments	20,000
Sale of waste paper	450	Electricity Charges	1,450
		Balance c/d	9,000
	47,100		47,100

Prepare the Club's Income and Expenditure Account for the year ended 31st December, 1994 and its Balance sheet as on that date, after taking the following information into account:-

(a) There are 500 members, each paying an annual subscription of Rs. 50, Rs. 500 being in arrears for 1993.

(b) Municipal taxes amounting to Rs. 400 per annum have been paid up to 31st March 1995, and Rs. 500 for salaries is outstanding.

(c) Buildings stood in the books at Rs. 50,000 and it is required to write off depreciation at 5 per cent.

(d) Three per cent interest has accrued on investments for five months.

Ans: *[Surplus: Rs. 14200: B/s Rs. 81450]*

8. The following is the statement of Receipts and Payments of Mumtaz Hospital for the year ending 31st December 1992.

Opening Balance:	*Rs.*	*Payments*	*Rs.*
Cash	500	Furniture purchased	100
Bank	8,000	Salaries	23,000
Govt. Securities	1,80,000	Instruments purchased	500
Receipts:		Diet expenses	2,000
Subscriptions	25,000	Surgery and dispensary	1,000
Interest	9,000	Rent and taxes	500
Donations	4,000	Insurance	200
Miscellaneous	300	Office expenses	700
		Miscellaneous expenses	100
		Closing Balances:	
		Bank	18,000
		Cash	700
		Govt. Securities	1,80,000
	2,26,800		2,26,800

You are asked to prepare the Income and Expenditure Account for the year and the Balance Sheet as on 31st December 1992. The other assets on 1st January 1992 were: Furniture, Rs. 2,000: Land, Rs. 50,000; Building Rs. 1,50,000; Instruments, Rs. 3,500. The Govt. Securities of the face value of Rs. 2,00,000 (cost Rs. 1,80,000) represent investments of the 1991 Endowment Fund. The subscriptions received include Rs. 10,000 for the year 1991 but Rs. 7,000 is outstanding for 1992 Salaries paid include Rs. 1,000 for 1991 but Rs. 1,500 is payable for 1992. Interest received includes Rs. 2,000 for 1991 but Rs. 2,300 is outstanding for 1992.

Ans: *[Surplus: Rs. 3600: B/s Rs. 414100]*

9. Below given was the Receipts and Payments Account of Crescent Club for the year ending 30th September 1994.

Receipts	*Rs.*	*Rs.*	*Payments*	*Rs.*
Balance b/d:			Secretary's Honorarium	4,800
Cash in hand	150		Rates and taxes	1,260
Cash at Bank	8,230	8,380	Printing and stationery	470
Subscriptions		10,710	Sundry expenses	1,530
Receipts for Dinner		2,400	Wages	840
Net Receipts for Recreation		4,270	Dinner expenses	2,390
Bank Interest		230	Bar stock purchased	5,770
Bar Receipts		7,450	Repairs	320
Cash paid in excess than the balance		20	Car purchased (excluding Rs. 3,000 received from the sale of an old car)	12,600
			Balance as per pass Book c/d	3,480
		33,460		33,460

Additional information was as follows:

	1.10.1993	30.9.1994
Subscriptions receivable	1,200	980
Cheques issued for printing not presented for payment	90	30
Club Building (Cost)	29,000	
Depreciation on Buildings	18,800	
Car purchases price	12,190	
Depreciation on car	10,290	
Value of Bar stock	710	870
Amount payable in connection with Bar stock	590	430

Cass paid in excess than the balance, Rs. 20 relates to Secretary's Honorarium. Due to lack of money in the club, secretary not collected the amount. But Rs. 4,800 includes the full Honorarium for the year 1993 – 1994.

Depreciate club buildings at 5 % under written down value method and car at 15 % for the complete year.

After adjusting Bank balance as per cash book prepare club's Income and expenditure account for the year ending 30th September 1994 and a Balance Sheet as on that date.

Ans: *[Surplus: Rs. 6090: B/s Rs. 28250]*

10. From the following prepare an Income and Expenditure Account for the year ended 31st March, 1995 and a Balance Sheet for the same date:

1994	*Rs.*	*1995*	*Rs.*
April 1		March 31	
Balance:		Salaries	3,600
Cash at Bank	455	Rent	600
Cash in office	55	Printing & Stationery	145
1995		Postage	25
March 31		Bicycle (purchase)	95
Subscription (including Rs. 200 for 1995 – 96	3,000	Prize Bonds	680
		Balance:	
Interest on Investments (cost of investments Rs. 30,000)	1,500	Cash in office	12
		Cash at Bank	113
Bank interests	10		
Sale of scooter	250		
	5,270		5,270

Subscriptions include Rs. 120 for 1993 – 1994. Also rent includes Rs. 50 paid for March 1994. Subscriptions amounting to Rs. 150 have still to be collected for the year 1994 – 95). Rent for March 1995 has still to be paid and Rs. 25 are outstanding against a stationary bill. The book value of the scooter was Rs. 320.

Ans: *[Deficit: Rs. 125: B/s Rs. 31050]*

11. Following is the Receipts and Payments Account of an Officer's Club for the year ended 31st December 1993:

	Rs		*Rs.*
Opening Balance	8,000	Salaries	3,600
Subscription:		Stationary	350
1992	2,000	Telephone Charges	400
1993	18,000	Insurance	1,200
1994	1,500	Miscellaneous expenditure	480

Entrance fees	1,300	Subscriptions to newspapers	640
Sale of old Magazines	50	Purchase of Sports Material	6,000
Interest on Investments	500	Closing Balance	19,480
Other Receipts	800		
	32,150		32,150

1992 December 31st — Balances of investments Rs. 10,000, Furniture Rs. 5,000, Buildings Rs. 25,000; Subscriptions due Rs. 3,000, Subscriptions received in advance of 1993 Rs. 2,000; Stock of sports material Rs. 4,000; Stock of stationery Rs. 200. The Balance as on 31st December 1993 are — subscriptions due Rs. 2,500; Stock of sports material Rs. 3,000 and stock of stationary Rs. 150. Depreciate furniture by 10 % and buildings by 5 %. Interest due on investments Rs. 500. Prepare Income and Expenditure Account and Balance Sheet.

Ans: *[Surplus: Rs; 10180: B/s Rs. 64880]*

12. The following is the account particulars of Golf Club for the year 1994. From these, you are required to prepare Receipts and payments account for the above said year:

	Rs.
Entrance fees received	2,500
Subscriptions:	
Received during the year 1994	19,800
1993 arrears	1,750
1994 arrears	1,650
Received in advance in 1993	550
Received in advance in 1994	450
Green fee received during the year 1994	600
Expenses paid – 1994	27,250
Expenses outstanding — 1994	1,470
Expenses outstanding in 1993	1,250
Surplus in Bar account	7,500
Secretary's Honorarium	1,500
Cash in hand–Opening Balance	2,350
Locker rent received	500
Investments purchased during the year cost	1,100

Ans: *[Cash Balance Closing Rs. 4350]*

13. From the following Trial Balance and adjustment particulars of a Gujranwala Club, you are required to prepare an Income and Expenditure account for the year ending 31st December, 1990 and a Balance Sheet as on that date:

	Dr.	*Cr.*
	Rs.	Rs.
Club Buildings	37,400	
Library Books	2,280	
Furniture and fittings	3,520	
Glassware and cutlery 1.1.1990	2,000	
Glassware and cutlery purchased during the year	1,000	
Printing and stationary	225	
Hall rent		3,670
Rent		6,700
Subscriptions		12,150
Recreations	345	
Receipts from Billiard Room		3,845
Billiard Board	10,400	
Billiard room expenses	2,135	
Profit from sale of cold drinks etc.		1,200
Subscriptions due as on 1.1.1990	1,125	
Honorarium	1,150	
Tickets sold for Annual Dinner		1,600
Expenses of Annual Dinner	1,875	
Staff salaries	2,700	
Donations		8,500
Audit fees	600	
Repairs and clearing	350	
Newspapers and Magazines	180	95
Interest on Bank deposit		25
Bank charges	20	
Entrance fees		225
Expenses on elections	2,995	
Stock Cold drinks etc. on 31.12.90	300	
Sundry creditors		3,135
Cash in hand	1,400	
Cash at Bank	1,735	
General Reserve		32,940
	74,085	74,085

Adjustments:

1. Stock of stationery on 31.12.1990 Rs. 35.
2. Subscriptions received in advance, Rs. 760.
3. Rent receivable, Rs. 500.
4. Salary outstanding Rs. 200.
5. Capitalize entrance fees.
6. Rs. 3,600 from donations relates to Election Fund 50 % of the remaining donations should be capitalized.
7. Depreciate library books at 10 %, Furniture and fittings at 15 %, Club Buildings at 5 % and Glass ware and cutlery as under:

1/5th of the cost in the year of purchase and 2/5th each in the next two years. Of the balance of Rs. 2,000 as on 1.1.1990, Rs. 1,000 is in the club for the last two years and the remaining Rs. 1,000 is purchased in the previous year.

Ans: *[Surplus: Rs. 15929: B/s Rs. 56244]*

14. From the following Receipts and Payments Account of Women's Club prepare an Income and Expenditure Account for the year ended with 31st December 1994 and a Balance Sheet as at that date:

Receipts	*Rs*	*Payments*	*Rs.*
Balance at Bank		Salaries	5,600
and in hand	2,000	Printing & stationery	1,750
Subscriptions arrears (1993)	200	Investments (at par)	4,000
Subscriptions (1994)	7,500		
Subscriptions (1995)	400	Expenditure on Refreshments	3,200
Sale of Furniture at book value	200	Expenses of the Previous year 1993	200
Donations for a stage drama	4,000	Improvements to Buildings	3,000
Interest on Investments	900	Cost of Gold Medal	350
Charges for refreshments	4,300	Balance at Bank and in hand	1,400
	19,500		19,500

In addition on the above the following further information is available from the accounts of the club:

(a) The assets on 1st January 1994 include buildings Rs. 20,000, 6 % investments Rs. 10,000 at par (including Prize Fund) and furniture
Rs. 1,000. The liabilities as on 1st January 1994 include an account styled Prizes Fund Account Rs. 8000.

(b) Of salaries Rs. 400 pertains to last year and Rs. 500 is still owing. As regards subscriptions in arrears of Rs. 200 received during the year, a provision of Rs. 150 was made in the accounts last year, Rs. 400 subscriptions for 1994 is outstanding.

(c) Stock of refreshments at the end of the year was valued at Rs. 100.

(d) Sports equipment worth Rs. 1,000 was donated during the year by a member.

(e) Printers' bill Rs. 100 is outstanding on 31st December 1994.

(f) A bill for Rs. 500 for purchase of furniture is outstanding.

(g) The investments (6 %) were purchased at the beginning of year and the interest on the investment has not been collected.

Ans: *[Surplus: Rs. 1960: B/s Rs. 41440]*

15. **Prepare Receipts and Payments Account and Income and Expenditure account of a Library for the year ended 31st December 1992.**

	Rs.
Subscriptions received (including Rs. 4,000 for the year 1991)	30,000
Donation received	2,000
Subscription outstanding	6,000
Purchase of furniture (life 10 years) at the beginning of year	1,000
Purchase of the year (Books)	2,500
Purchase of magazines and newspapers	1,200
Sale of all old furniture at the beginning of the year (Book value, Rs. 300)	500
Opening Cash Balance	6,800
Investments purchased	4,000
Interest (on investments) received	1,000
Bank charges	20
Postage, Telegram and Telephones	1,800
Printing and Stationery (one bill of Rs. 300 for last year)	1,000
Printers bill outstanding	500
Entrance fees (50 % to be capitalized)	1,400
Legacies received (to be capitalized)	2,000
Rent paid (including Rs. 200 for the year 1991)	3,600
Outstanding rent	300

Ans: *[Q. Cash Bal. Rs. 28580: Surplus: Rs. 25880]*

16. **The following was the financial position of a Public Library as on 30.06.1990.**

Assets		*Rs.*	*Liabilities*	*Rs.*
Cash		3,300	Capital Fund	44,350
Furniture		4,800	Outstanding expenses	650
Debtors:				
Subscriptions due	750			
Rent due	350	1,100		
Books account		16,800		
Investments		5,000		
Buildings		14,000		
		45,000		45,000

The following were the cash transactions of the year:

	Rs		*Rs.*
Balance b/d	3,300	Salaries	2,400
Entrance fees	2,600	Municipal taxes	700
Subscriptions	8,500	Insurance	500
Received on sale of old furniture	600	Additions to library	1,250
Received on sale of old newspapers	60	Outstanding expenses paid	650
Rent	1,040	Repairs	250
Proceeds from		Electric Installation Expenses	4,500
entertainment programmes	3,000	Printing and Stationery	400
		Sundry Expenses	200
		Balance c/d	8,250
	19,100		19,100

It was ascertained that Rs. 1,500 were outstanding by way of subscriptions and Rs. 400 were receivable towards rent. Insurance was prepaid to the extent of Rs. 200. There were outstanding expenses due Rs. 900.

Prepare Income and Expenditure Account and Balance Sheet as on 30th June, 1991 after providing for depreciation on building at 3 %, writing down investments by 5 % and Library books by 10 per cent.

Ans: *[Surplus: Rs. 8500: B/s Rs. 53750]*

NOTE:

Furniture sold is to be deducted from Furniture in the Balance Sheet. It is not an income. Depreciation is to be calculated on the opening balance of the assets.

17. The Balance Sheet of Dayal Singh Library stood as follows on 31st March 1993:

Assets	*Rs*	*Liabilities*	*Rs.*
Cash at bank	4,0000	Outstanding creditors for expenses	7000
Subscriptions due	1,0000	Creditors	43000
Rent receivable	4000	Capital fund	700000
5 % investments	6,0000		
Library books	200000		
Furniture	35000		
Buildings	400000		
Prepaid Insurance	1000		
	750000		750000

The cash transactions for the year ending 31st March 1994 were as follows:

Receipts	*Rs*	*Payments*	*Rs.*
Balance b/d	40000	Payments to creditors	43000
Entrance fees	12000	Additions to Library	14000
Subscriptions	125000	Electric light	3000
Proceeds from entertainments	45000	Municipal taxes	11000
Rent	15000	Repairs	8000
Interest on investments	2000	Insurance	3500
Sale of old newspapers	4500	Electric installation expenses	20000
Sale of old Furniture	1000	Payment to creditors for expenses	7000
		Printing and Stationery	5000
		Sundry expenses	2500
		Postage	4200
		Subscriptions to periodicals	14000
		Investments purchased	30000
		Salaries	36000
		Balance c/d	43300
	244500		244500

Insurance was prepaid to the extent of Rs. 750 and subscriptions outstanding amounted to Rs. 18000. Rent receivable is Rs. 3000 and Rs. 4000 for interest on investments had accrued due. Creditors outstanding for the purchase of Almirah during the year amounted to Rs. 15000. Also outstanding were salaries Rs. 6000 and stationery Rs. 500. Entrance fees has to be capitalized. Depreciate Buildings by 2 per cent. Furniture by 10 % and Library books 10 per cent. Such depreciation to be calculated on the opening balance of the assets in question.

You are required to prepare Income and Expenditure Account for the year and the Balance Sheet as on 31st March 1994.

Ans: *[Surplus Rs. 77050: B/s Rs. 810550]*

18. The Balance of Larkana Club as on 31st December 1990 are given below. You are required to prepare an Income and Expenditure Account and Balance Sheet as on 31st December, 1990.

	Rs.
Cash in hand	1,000
Cash at Bank	23,500
Investments	1,60,000
Creditors	8,000
Gas and Electricity	9,400
Rent, rates and taxes	12,000
Salaries to staff	62,000
Salary of the secretary	40,000
Stationary	26,000
Newspapers and Magazines	8,000
Repairs and Renewals	12,000
Annual subscription	1,57,500
Profit from the sale of Bar items	12,000
Entrance fees	2,100
Life Membership fees	44,000
Receipts from Billiards Room	15,000
Dividend from investments	8,000
Accumulated funds (capital a/c)	2,52,300
China glass and cutlery	30,000
Furniture	1,00,000
Closing stock of Bar items	15,000

Adjustments:

Salaries of staff due	Rs. 1,000
Stock of stationery in hand	Rs. 2,000
Annual subscription due	Rs. 12,600
Annual subscription paid in advance	Rs. 6,300
Depreciate china glass and cutlery by 10 %	
Depreciate furniture by 5 %	

Ten per cent of life membership fees is to be taken to Income and expenditure Accounts.

Ans: *[Surplus: Rs. 28900: B/s Rs. 336100]*

19. Given below is the Receipts and Payments Account of the Faisalabad Recreation Club for the period ending 31st December, 1994:

	Rs.			Rs.
Donation A/c – being donations received	25,000	Buildings		20,000
Reserve Fund – being life members fees and entrance fees received	2,000	Expenses incurred on Quadrangular matches		450
		Furniture		1,050
Quadrangular match fund, being prescribed matches fees received	5,000	*Revenue Payments:*		
		Salaries	900	
		Cricket	300	

Revenue Receipt:			Tennis	270	
Subscriptions (including)			Insurance		
Rs. 100 of 1995	1,600		(paid for the year ending		
Locker's rent	50		30th Sept. 1995	180	
Interest on securities	50		Gardening	85	
Cricket	200		Printing etc.	15	
Sundries	25		Telephone	125	
Tennis	175		Sundries	75	1,950
Billiards	100	2,200	Investments at cost		9,000
			Balance c/d		1,750
		34,200			34,200

Subscriptions receivable for the year 1994 were Rs. 150. Salaries outstanding for the month of December 1994 were Rs. 85.

From the above particulars you are required to prepare Income and Expenditure Account for the year ending 31st December 1994 and a Balance Sheet as on that date.

Ans: *[Surplus: Rs. 350: B/s Rs. 32085]*

20. From the following particulars relating to Chand Cricket Club, prepare Income and Expenditu: Account for the year ending 31st March 1993 and Balance Sheet as at that date.

ABSTRACT OF CASH BOOK

	Rs		*Rs.*
Subscriptions	10,000	Upkeep of field	4,000
Admission fee	600	Expenses of Tournament	1,400
Sale of old balls etc.	100	Insurance	400
Hire of ground	600	Telephone	100
Subscriptions for Tournament	2,000	Printing & Stationary	300
Bank drawn	8,000	Secretary's conveyance	340
Donations	20,000	Bats & Balls etc.	1,460
		Bank lodged	33,300
	41,300		41,300

Assets on 1s April 1992	*Rs.*
Cash at Bank	6,000
Stock of balls etc.	3,000
Printing & Stationery	400
Subscriptions due	1,000
Liabilities on 1st April 1992	Nil

Donations and surplus on account of tournament should be kept in reserve for a permanent pavilion. Subscriptions due on 31st March 1993, Rs. 1,500. Write off 50 % of Bats and Balls Account and 25 % of Printing and Stationery Account.

Ans: *[Surplus: Rs. 4555: B/s Rs. 35555]*

CHAPTER - 18

CONSIGNMENT ACCOUNTS

CONSIGNMENT ACCOUNTS

In today's world of business, every manufacturer or exporter or wholesaler tries his best to sell his products in his own country and abroad to a larger extent. But it is not an easy task, because a businessman cannot have the exact information about the demand of his product in different parts of the country and abroad. There are two methods by which businessmen can increase the sale of their products, (1) by opening their own branches in different parts of the country and abroad (2) by appointing agents in their own country as well as abroad. The first method is very expensive because a large sum of money is spent on the establishment of a branch and a number of persons are required as, manager, clerks, accountant etc. to carry out different operations of the branch. Inspite of spending such a heavy amount, the branch may prove un-successful or the profit earned by the branch may be very small as compare to the amount invested in the branch.

So far as the second method is concerned, the manufacturer or wholesaler just appoints an agent who sells goods on behalf and on the risk of the former. The agent is paid commission which is generally a percentage of sales made by him. This is comparatively a cheaper method by which sales can be promoted. This arrangement proves very useful due to the knowledge of the agent of the local conditions. The agent will try to sell the goods in the best possible manner and will remit the sale proceeds of the goods after deducting expenses and his own commission to the manufacturer or wholesaler.

Consignment is an act of sending the goods by the owner (manufacturer or whole saller) to his agent, who agrees to collect, store and sell them on the risk and behalf of the owner on commission basis. The manufacturer or wholesaler who sends his good for sale is known as **'Consignor'** and the person to whom the goods are sent is known as the **'Consignee'**. The relationship between consignor and consignee is that of **'Principal and Agent'** and not that of seller and buyer. It should be noted, carefully, that the consignee is not the buyer, he merely possesses the goods on behalf of the consignor. He is liable to make the payment to the consignor only to the extent the goods he has sold. Unsold goods belong to the consignor and are held by the consignee at the risk of the consignor.

When goods are dispatched by the consignor to the consignee, it will be a **'Consignment Outward'** from consignor's view point and **'Consignment Inward'** from consignee's view point.

A consignor may have a number of agents in different parts of the country or abroad to whom he sends good for sale. So, it will be very useful for him to maintain a separate subsidiary register (journal) with a view to keep full record of the goods consigned. This special register is named as **'Consignment Outward Book or Journal'**. Accounting treatment of this book is similar to that of a sales book. On the other hand, a consignee may have a number of consignors from whom he receives goods for sale, so it will be very convenient for him to maintain a separate subsidiary register named as **'Consignment Inward Book'**. However for solving the problems in the examination Journal is used for recording consignment transactions.

When goods are sent by the consigner to the consignee, he has to incurred some expenses on the goods consigned, such as carriage, dock dues, import duty, transportation, godown rent, Insurance etc. It should be remembered that generally all the expenses either paid by the consignor himself or by the consignee are borne by the consignor. The consignee will neither bear any expense or loss nor he will share the profit made on the sale of goods. he will just receive his commission from the consignor.

ACCOUNT SALES:

It is a report prepared by the consignee and sent to the consignor, periodically, which shows the details about the sale of goods; the price at which goods are sold; expenses paid by the consignee on behalf of the consignor; agent's commission and the net balance for which he is liable. On the basis of this report or statement (Account sales) the consignor gets certain information regarding the gross sale proceeds, expenses paid by the consignee on his behalf, consignee's commission and net balance due from the consignee. All these information is then recorded in books of the consignor. The specimen of Account sales is given below;

ACCOUNT SALES

Consignment of 800, tons of coal sold on behalf of the consignor. A & Co. by M/s B & Co.

		Rs.	Rs.
	Sold (800 tons at the rate of Rs. 200 per ton: 800 × 200)		1,60,000
	Less: Expenses paid by us and Commission		
	Duty & Taxes:	10,000	
	Godown Rent	2,000	
	Insurance of godown	5,000	
	Commission 5 % of Sales	8,000	25,000
			1,35,000
	Less Advance		50,000
	Balance due and bank draft enclosed		85,000

Signed:

M/s B & Co.

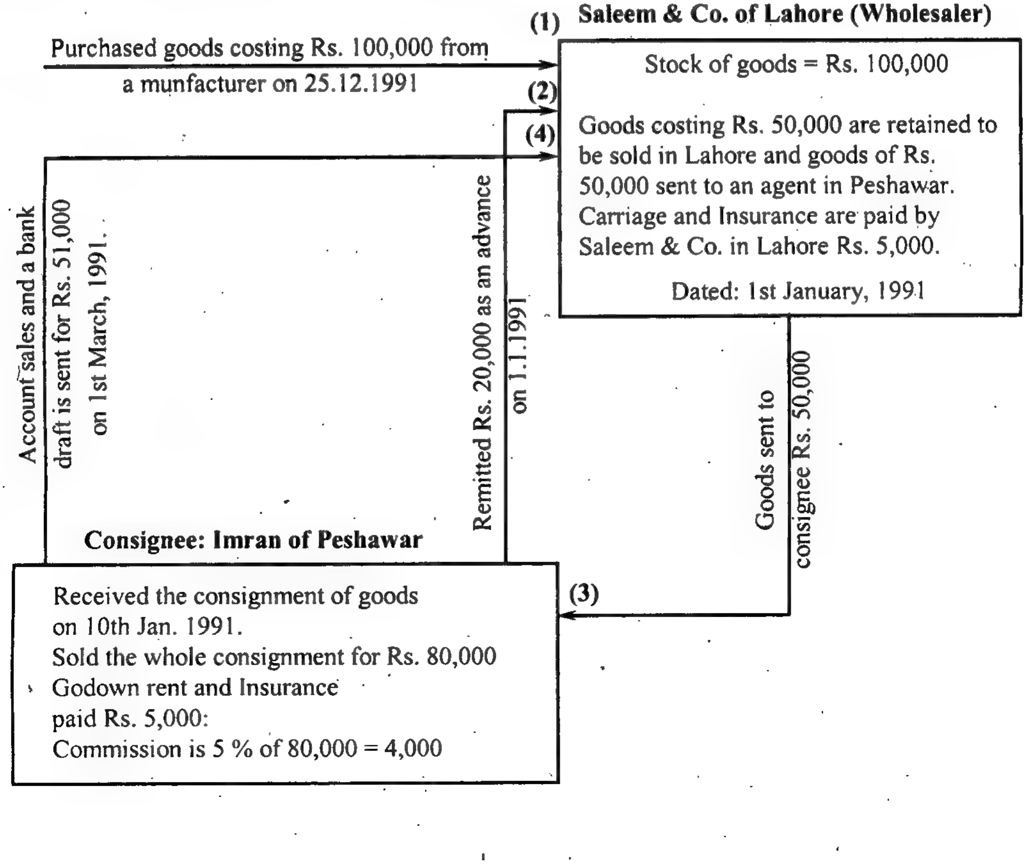
NOTE: Sometimes an amount is remitted by the consignee or a bill is accepted by him as an advance to the consignor. He deducts this amount from the sale proceeds of the goods:

Difference between goods Consigned and Goods Sold:

The following are the points of distinction:

Basis	Consignment	Sale
1. Ownership:	Not transferred to the consignee, it remains with the consignor.	Ownership passes to the buyer.
2. Relationship:	Relationship between consignor and consignee is that of principal and agent	Buyer is the debtor of the seller until his account is settled.
3. Risk and damages:	Consignee holds the goods at the risk of the consignor, so any damage to the goods is a loss to the consignor.	Any damage to the goods is the loss of the buyer.
4. Return of goods:	The consignee may return the goods to the consignor if not sold.	Goods once sold are generally not returned.
5. Expenses after delivery:	To be borne by the consignor.	To be borne by the buyer.
6. Forwarding document:	Performa–Invoice	Invoice.

The whole concept and procedure of consignment is explained below with the help of Figure 1 and notes given below the Figure.



NOTES:

(1) Saleem & Co. of Lahore (the consignor) purchased goods costing Rs. 1,00,000 from a manufacturer. Out of the purchased goods, they sent goods of Rs. 50,000 to their agent Imran (the consignee) in Peshawar. The remaining goods are retained by the consignor to sell themselves in Lahore. Saleem & Co. paid carriage on good (from Lahore to Peshawar) and insurance Rs. 5,000. The goods are dispatched on 1st January, 1991.

(2) On the same date, they received Rs. 20,000 as an advance from the consignee. (Imran)

(3) On 10th January, 1991, the consignee received the consignment. The consignee sold the whole consignment for Rs. 80,000 and paid godown rent and insurance amounted to Rs. 5,000. He charged his commission at the rate of 5 % of total sales i.e. $80,000 \times \frac{5}{100} = 4000$.

(4) He prepared a report (Account sales) containing the information regarding, sale proceeds of goods, expenses paid by him on behalf of the consignor, his commission and the amount paid as an advance and sent to the consignor along with a bank draft of Rs. 51,000 (Sale proceeds of Rs. 80,000 Less amount paid as an advance Rs. 20,000 less expenses paid Rs. 5,000, less his commission Rs. 4,000).

Now the profit earned by the consignor on this consignment is calculated as follows:

	Sale proceeds of Goods:		80,000
Less:	Cost of goods in Lahore	50,000	
	+ Carriage and Insurance paid in Lahore	5,000	
	+ Godown rent and insurance paid by the consignee	5,000	
	+ Consignee's commission 5 % of sales:	4,000	64000
	Profit earned by the consignor		16000

IMPORTANT TERMS AND CONCEPTS:

(a) PROFORMA INVOICE:

Invoice is the forwarding letter sent along with the goods containing particulars as to the name of the item; number (quantity or weight or measurement) and the price. As the consignment is not sale and the consignee is not the buyer therefore the 'forwarding letter' sent along with the consignment is meant only for his information. This forwarding letter is a substitute of invoice but it is drawn up in the form of an invoice and termed a ***"Performa Invoice"***.

(b) DELCREDERE COMMISSION:

When such commission is paid to the consignee, the loss on account of bad debts is borne by consignee. This commission will save consignor from loss of bad debts only. If any non– recovery from customer is not in the nature of bad debt (Non–payment due to credit unworthiness of customer) such loss will be borne by consignor, even if delcredere commission is being paid to consignee.

(c) EXPENSES BORNE BY CONSIGNEE:

If as per agreement, any expense is borne by consignee, or any loss occurs due to negligence of consignee, such expense or loss will not be debited in consignment account by consignor. Such expense will be debited in the profit and loss account of the consignee.

(d) DISCOUNT PAID ON BILLS RECEIVABLE DISCOUNTED BY CONSIGNOR:

There are two alternative treatments for this item:

(i) When discount is treated as "consignment expense" it is debited to consignment account.

(ii) When discount is treated as "financial charge", it is debited to profit and loss account.

(e) GOODS INVOICED AT A PRICE ABOVE COST:

If consignor sends Performa invoice to consignee at a price above cost, profit will be calculated on the basis of cost. Therefore, adjustment shall be made for excess of invoice price over cost included in the value of "goods sent on consignment" and "consignment stock".

(f) ABNORMAL LOSS OF STOCK:

Any abnormal loss e.g. loss due to fire, accident, theft, negligence, etc. will be treated in the books of consignor in such a manner that consignment profit is not reduced. While calculating the value of loss, proportionate expenses up to the time of occurrence of loss are included.

(g) NORMAL LOSS OF STOCK:

A loss which occurs due to natural causes e.g. normal leakage, loss in weight due to nature of goods, etc. is termed as 'normal loss'. Such loss inflates the value of closing stock.

(h) VALUATION OF CLOSING STOCK WITH CONSIGNEE:

Closing stock with consignee is valued at cost or market price whichever is less. To ascertain cost proportionate non–recurring expenses are included in the value of stock. Non–recurring expenses will include all such expenses, which have been incurred up to the time goods have reached to agent's selling place e.g. freight, cartage, transit insurance, octroi, import duty, customs charges, packing, etc. will be included for stock valuation. Expenses like godown rent, godown insurance, sales expenses are not included in the value of stock. Market value is the net realizable value i.e. sales commission and other variable sales expenses are deducted from the market value on the closing date.

(j) OVERRIDING COMMISSION:

Extra commission is normally granted by the consignor when he desires his agent to work hard to push a new line of product in the market.

CONSIGNOR'S BOOKS:

As already stated the goods sent by the consignor are sold on his behalf therefore he would like to know the profit earned or loss suffered from each different consignment. Before we discuss the entries in the books of the consignor it is helpful to understand **the nature of the following:**

CONSIGNMENT ACCOUNT:

This is by nature a profit & Loss Account. One separate account is devoted to each different consignment with the heading "Consignment to ... account". Actually the consignment account **is a particular Trading and Profit and Loss Account.** All expenses specially related to the consignment must be debited to the concerned consignment account whether incurred by the consignor or by the consignee and all revenues (goods sold by the consignee and unsold goods with the consignee) should be credited to this account. The difference between the two sides of this account will show the result of that particular consignment.

CONSIGNEE'S ACCOUNT:

This is a personal account. It should be noted that the consignee is not the buyer. His personal account, therefore, is not debited when goods are sent to him. In cases where it is customary for the consignee to send some money as an advance against the consignment **the payment is merely an advance** (by way of security) **and not a part payment.** Hence the advance received from the consignee should be posted to the credit side of consignee's personal account. In case part of the stock is still lying unsold the proportionate amount of advance should be carried down as credit balance in consignee's personal account. In case where consignor draws a bill on consignee the bill is known as a **documentary bill.**

JOURNAL ENTRIES TO BE THE BOOKS OF CONSIGNOR:

Consignor maintains a separate consignment account for goods sent to each agent. Balance of consignment account is profit or loss.

1.	**On sending goods to Consignee:**	Consignment A/c .... Dr. Goods sent on consignment A/c (Being goods sent to agent for sale)

Note: I. In case a consignor has more than one agent, separate consignment account is prepared for each agent. Each consignment account is identified with the name of place, for example 'Consignment to Karachi A/c or 'Consignment to Lahore A/c.

II. If goods have been sent to agent at a prince above cost, adjustment shall be made with the difference between cost and invoice price of goods.

2.	**For adjustment of the difference between Invoice price and cost price:**	Goods sent on consignment A/c .... Dr. Consignment A/c (Being excess of invoice price over cost price of goods sent adjusted)
3.	**For expenses paid by consignor:**	Consignment A/c .... Dr. Cash/Bank A/c (Being expenses paid)

4.	**On receiving advance from consignee:**	Cash/Bank A/c .... Dr. Consignee A/c (Being advance received from agent)
5.	**If consignee has accepted a bill of exchange as an advance:**	Bills Receivable A/c .... Dr. Consignee A/c (Being acceptance received from agent)
6.	**With the sale price of goods sold by consignee:**	Consignee A/c .... Dr. Consignment A/c (Being goods sold by agent)
7.	**For goods taken over by consignee for his personal use:**	Consignee............ Dr. Consignment A/c (Being goods taken over by agent)
8.	**For expenses paid by Agent:**	Consignment A/c............ Dr. Consignee (Being expenses incurred by agent)

Note: If any of the expenses is borne by the agent personally, such expenses will not be debited to consignment A/c. Consignor will not make any entry for such expenses. These will be debited to the Profit and Loss account in the books of Consignee.

9.	**For unsold goods with the consignee:**	Consignment Stock A/c............ Dr. Consignment A/c (Being value of closing stock with agent)

Note: If invoice value of stock is more than cost, the excess of invoice price over cost will be adjusted.

10.	**For adjustment of closing stock:**	Consignment A/c............ Dr. Consignment Stock Reserve A/c (Being profit included in stock adjusted)

11. For abnormal Loss of goods:

(a) 1st Method:

(i)	**For total value of goods damaged:**	Loss of Stock A/c............ Dr. Consignment A/c (Being total value of loss of stock)

(ii)	**For amount of insurance claim:**	Bank/Insurance Co. .... Dr. Loss of Stock A/c (Being insurance claim for loss)
(iii)	**For sale proceeds of damaged goods:**	Consignee........ Dr. Loss of Stock A/c (Being damaged goods sold by agent)
(iv)	**For Net loss of stock:**	Profit and Loss A/c .... Dr. Loss of Stock A/c (Being net loss of stock transferred to P/L A/c)

(b) IInd Method:

(i)	**For amount of Insurance claim:**	Bank/Insurance Co .... Dr. Consignment A/c (Being amount of insurance claim)
(ii)	**For sale proceeds of damaged goods:**	Consignee........ Dr. Consignment A/c (Being damaged goods sold by agent)
(iii)	**For net loss of stock:**	Profit and Loss A/c .... Dr. Consignment A/c (Being amount of net loss transferred to P/L A/c)

Note: If damaged goods have not been sold, net realizable value of such goods will be include in closing consignment stock.

12.	**For profit on consignment:**	Consignment A/c........ Dr. P & L A/c (Being net profit on consignment)

Note: In case of loss (debit balance of Consignment A/c exceeds credit balance) reverse entry will be made.

JOURNAL ENTRIES IN THE BOOKS OF CONSIGNEE:

1.	**On payment of Advance to consignor:**	Consignor .... Dr. Cash/Bank A/c (Being advance paid to consignor)
2.	**On acceptance of bill of exchange in favor of consignor:**	Consignor .... Dr. Bills payable A/c (Being acceptance given to consignor)
3.	**On payment of expenses for consignor:**	Consignor .... Dr. Cash A/c (Being expenses paid on behalf of consignor)
4.	**On payment of expenses to be borne by consignee:**	Expenses A/c .... Dr. Cash A/c (Being expenses paid)

Note: These expenses will be transferred to Profit and Loss Account of consignee.

5.	**On sale of goods for cash:**	Cash A/c .... Dr. Consignor (Being goods sold for cash on behalf of consignor)
6.	**On sale of goods on credit:**	Sundry Debtors .... Dr. Consignor (Being goods sold on credit on behalf of consignor)
7.	**For commission of consignor:**	Consignor .... Dr. Commission A/c (Being commission earned on consignment sale)

Note: There may be a separate account regarding delcredere commission)

8.	**For goods taken over by consignee:**	Purchase A/c .... Dr. Consignor (Being goods taken over out of consignment stock)

9.	When there is realization from debtors:	Cash/Bank A/c .... Dr. Sundry Debtor (Being amount realized from debtor)
10.	If there is bad debt on above realization and consignee does not receive delcredere commission	Consignor A/c .... Dr. Sundry Debtor (Being bad debt on realization from debtor)
	But if he receives delcredere commission:	Commission A/c .... Dr. Sundry Debtor (Being bad debts charged from commission earned)
11.	For final payment to consignor: (A) Payment in Cash/Bank Draft:	Consignor .... Dr. Cash/Bank A/c (Being final payment made to consignor)
	(B) Payment by accepting a bill:	Consignor .... Dr. Bills Payable A/c (Being acceptance given to consignor in final settlement)

12. **Balance in the Commission Account will be transferred to Profit & Loss Account.**

ILLUSTRATION NO. 1

P sends 500 cases to Q on consignment basis. Each case costs Rs. 100 to P. Consignor spends Rs. 300 in dispatching the cases. The consignee is entitled to receive 6 % commission on sales plus the expenses incurred by him. He advances immediately Rs. 10,000 to the consignor. Later, Q sends Account Sales which discloses the following details:

300 Cases sold @ Rs. 200 each

200 Cases sold @ Rs. 220 each

Railway freight and carriage Rs. 12,500

Godown Rent and Insurance Rs. 2,500

Q remits a Bank Draft for the balance account.

Show Journal Entries and Ledger Accounts in the books of consignor and consignee.

Solution:

JOURNAL OF CONSIGNER (P)

				Rs.	Rs.
	Consignment A/c	Dr.		50,000	
	Goods sent on Consignment A/c				50,000
	(Being goods sent on consignment basis to Q				
	Consignment A/c	Dr.		300	
	Cash A/c				300
	(Being expenses incurred for dispatching the goods)				
	Cash A/c	Dr.		10,000	
	Q A/c				10,000
	(Being advance received from Q				
	Q A/c	Dr.		1,04,000	
	Consignment A/c				1,04,000
	(Being sales of 500 cases by consignee)				
	Consignment A/c	Dr.		15,000	
	Q A/c				15,000
	(Being expenses incurred by consignee)				
	Consignment A/c	Dr.		6,240	
	Q A/c				6,240
	(Being commission on sale @ 6 % of sales)				
	Consignment A/c	Dr.		32,460	
	Profit & Loss A/c				32,460
	(Being profit earned on consignment)				
	Bank A/c	Dr.		72,760	
	Q A/c				72,760
	(Being bank draft received from Q in final settlement)				
	Goods Sent on Consignment A/c	Dr.		50,000	
	Trading A/c				50,000
	(Being goods sent on consignment A/c transferred to trading A/c)				

CONSIGNMENT ACCOUNT

References		Rs.	References	Rs.
Goods sent on Consignment			Q (Sales)	
(500 Cases @ Rs. 100 per case)		50,000	300 cases @ Rs. 200 = 60,000	
Cash (Dispatching exp.)		300	200 cases @ Rs. 220 = 44,000	1,04,000
Q (Consignee)				
Freight and carriage Rs.	12,500			
Godown Rent and Insurance	2,500	15,000		
Q (Commission @ 6 % on 1,04,000)		6,240		
Profit & Loss A/c		32,460		
		1,04,000		1,04,000

Q'S ACCOUNT

References	Rs.	References	Rs.
Consignment A/c (Sales)	1,04,000	Cash A/c (Advance)	10,000
		Consignment A/c	15,000
		Consignment A/c	
		(Commission)	6,240
		Bank A/c	72,760
	1,04,000		1,04,000

GOODS SENT ON CONSIGNMENT ACCOUNT

References	Rs.	References	Rs.
Trading A/c	50,000	Consignment A/c	50,000
	50,000		50,000

IN THE BOOKS OF Q (CONSIGNEE)

			Rs.	Rs.
	P A/c Dr.		10,000	
	Cash A/c			10,000
	(Being advance paid to P (Consignor)			
	P A/c Dr.		15,000	
	Cash A/c			15,000
	(Being expenses paid for consignor)			
	Cash A/c Dr.		1,04,000	
	P A/c			1,04,000
	(Being goods sold on behalf of consignor)			
	P A/c Dr.		6,240	
	Commission A/c			6,240
	(Being commission on sales @ 6 %)			
	P A/c Dr.		72,760	
	Bank A/c			72,760
	(Being bank draft sent to consignor in final settlement)			

P (CONSIGNOR)'S ACCOUNT

References	Rs.	References	Rs.
Cash A/c (advance)	10,000	Cash (Sales)	1,04,000
Cash A/c (expenses)	15,000		
Commission (@ 6 % on Sales)	6,240		
Bank A/c (Final payment)	72,760		
	1,04,000		1,04,000

VALUATION OF UNSOLD STOCK:

In case where all the goods sent on consignment have not been sold at the time of preparing final accounts by the consignor **the unsold stock Is brought Into books** by means of journal entry:

Consignment stock account .... Dr.

Consignment account ....

The consignment stock account Is an asset and will be shown In the balance sheet. Next year It will be transferred to the debit side of the consignment account. The principle of valuing stock "Cost price or market price Ihever Is lower" applies In this case also. However, cost price means original cost of the unsold stock **plus proportionate amount of the expenses Ih are necessary to put the goods In their present place and condition** such as freight, octroi, duty, Insurance In transit, forwarding charges, carriage up to consignee's godown etc. Generally all expenses Incurred till the goods reach consignee's godown are treated as part of the cost whether Incurred by the consignor or consignee. Expenses Incurred In **storage and selling** the goods, after the goods reach consignee's godown are not to be IIed In the cost of the stock. Instances of the latter type of expenses are godown rent and Insurance for the godown and Interest etc.

EXAMPLE:

Salman & Sons of Lahore consigned 500 units of goods to Ramzan of Nairobi, the cost price of Ih Is Rs. 8,000. Salman & Sons paid the following expenses:

(a) Carriage Rs. 2,400 (b) Marine Insurance Rs. 960 I Freight Rs. 1,080. Ramzan Incurred the following expenses:

		Rs.
(d)	**Carriage from docks to consignee's warehouse**	**150**
(e)	**Import duty**	**450**
(f)	**Carriage to the buyer's where house**	**500**
(g)	**Commission**	**160**
(h)	**Expenses on goods sold**	**100**
(I)	**Warehouse rent (consignee)**	**50**

Out of 500 units 400 units were sold up to date. Find out the value of the closing stock on consignment.

Solution:

Expenses mentioned from (a) to (e) have been Incurred In making the goods saleable at the consignee's warehouse. The total (2,400 + 960 + 1,080 + 150 + 450) Rs. 5,040 should be added to the cost of unsold stock In such proportion that the unsold stock bears to the whole stock.

Total goods sent 500 units, goods unsold 100 units.

∴ Proportion of unsold stock to whole stock 5 : 1 or unsold stock Is one–fifth of the total goods sent on consignment.

	Rs.
Thus 1/5th cost of goods sent on consignment	1,600
Add: 1/5th expenses	1,008
Value of stock on consignment	2,608

Expenses connected with sales

(f) Carriage to buyer's warehouse

(g) Commission

(h) Expenses on goods sold.

(I) Warehouse rent are to be Ignored for the purpose of valuation of closing stock.

NOTE:

However where details regarding the nature of expenses Is not given In the question the expenses Incurred by the consignor will be taken Into account for valuation of closing stock. Expenses Incurred by the consignee will be Ignored.

ILLUSTRATION NO. 2

On 1st September, 1994 Qasim of Lahore sent 500 cases @ Rs. 150 each to Aziz of Karachi to be sold on his account and at his risk for $7\frac{1}{2}$ % commission and $2\frac{1}{2}$ % delcredere commission and Incurred Rs. 5,500 expenses. Rs. 20,000 advance has been received on 31st December 1994. Aziz sent an account sales disclosing that 300 cases have been sold for Rs. 230 each and another 100 cases @ Rs. 220 each. He has Incurred unloading expenses etc. Rs. 750 and selling expenses Rs. 1,000. He sends a bank draft for the net amount due.

Prepare ledger accounts In the books of Qasim.

Solution:

IN THE BOOKS OF QASIM
Consignment Account

		Rs.		Rs.
Goods sent out on consignment		75,000	Aziz – Sales	91,000
Bank (expenses)		5,500	Consignment stock account (1)	16,250
Aziz:				
Unloading expenses	750			
Selling expenses	1,000			
Commission $7\frac{1}{2}$ %	6,825			
Delcredere $2\frac{1}{2}$ %	2,275	10,850		
Profit and loss account		15,900		
		1,07,250		1,07,250

GOOD SENT ON CONSIGNMENT ACCOUNT

	Rs.		Rs.
Trading Account	75,000	Consignment account	75,000

CONSIGNsMENT STOCK ACCOUNT

	Rs.		Rs.
Consignment Account	16,250	Balance c/d	16,250

AZIZ'S ACCOUNT

	Rs.			Rs.
Consignment account (sales)	91,000	Bank	20,000	
		Consignment account:		
		Unloading expenses	750	
		Selling expenses	1,000	
		Commission	6,825	
		Delcredere	2,275	10,850
		Bank		60,150
	91,000			91,000

NOTE:

(1) The value of closing stock has been calculated as follows:

100 cases @ Rs. 150 each	Rs. 15,000
1/5th of expense Incurred by consignor	Rs. 1,100
1/5th of unloading expenses	150
	Rs. 16,250

ILLUSTRATION NO. 3

Suzuki Motors Ltd. consigned to their selling agent Star Motors In Lahore two cars costing Rs. 20,000 for sale on the basis of 8 per cent plus 2 per cent delcredere commission. Star Motors paid landing charges amounting to Rs. 1,300. Suzuki Motors Ltd. paid for carriage; freight and Insurance Rs. 1,700.

Consignee sold one car for Rs. 13,000 and remitted Rs. 11,500 on account. The second car was sold for Rs. 13,500 but Rs. 1,500 were not realized and became a bad debt.

Show the ledger accounts In the books of both the parties assuming that Star Motors settled the account with Suzuki Motors Ltd.

Solution:

Consignor's Books:

CONSIGNMENT TO LAHORE ACCOUNT

		Rs.		Rs.
Goods sent on consignment		20,000	Star Motors (Sales)	26,500
Bank (cartage, freight and Insurance)		1,700		
Star Motors:				
Landing charges	1,300			
Commission	2,650	3,950		
Profit and Loss A/c		850		
		26,500		26,500

STAR MOTOR'S ACCOUNT

	Rs.		Rs.
Consignment Account (Sales)	26,500	Consignment a/c:	
		Landing charges	1,300
		Bank	11,500
		Commission	2,650
		Bank	11,050
	26,500		26,500

NOTE:

Calculation of commission:

8 % on Rs. 26,500	Rs. 2,120
2 % on Rs. 26,500	Rs. 530
	2,650

Consignee's Books:

SUZUKI MOTORS LTD. ACCOUNT

	Rs.		Rs.
Bank (landing charges)	1,300	S. Debtors a/c	13,000
Bank (amount remitted)	11,500	S. Debtors a/c	13,500
Commission	2,650		
Bank (amount remitted)	11,050		
	26,500		26,500

COMMISSION ACCOUNTS

	Rs.		Rs.
Bad Debts.	1,500	Suzuki Motors Ltd.	2,650
Profit and Loss a/c	1,150		
	2,650		2,650

NOTE:

Since the consignee Is entitled to delcredere commission therefore bad debt Is his loss. As this loss Is related to this particular consignment It should be charged to commission on consignment account In the book of consignee.

INVOICING GOODS AT A PRICE HIGHER THAN COST PRICE:

So far we have dealt with the case when goods are Invoiced at cost price and the consignor makes the entries In his books at cost price. In many cases the consignor makes the Invoice at the selling price i.e. Performa Invoice price. The Idea Is that consignee should not know the actual cost of the goods. In such cases the entries are made by the consignor In his books at the Invoice price. But for ascertaining profit or loss on a consignment the sale proceeds must be compared with the actual cost. Therefore, every Item appearing In consignment account at Invoice price must be suitably adjusted so as to reduce It to the cost price. This process of adjusting Invoice price to the cost price Is termed as ***"unloading"***. The following, additional, entries are to be passed In the books of the consignor to effect unloading:

(1) For unloading the difference between Invoice price and cost price on the goods sent on consignment:

Debit Goods sent on consignment account and credit consignment account.

(2) For unloading the excess value put on the closing stock:

Debit consignment account and credit stock reserve account.

The effect of the first entry Is to reduce the balance on "Goods sent on consignment account" to the cost price. As usual It will be transferred to the trading account.

The effect of the second entry Is to show "Stock on consignment" In the balance sheet as follows:

BALANCE SHEET

	Assets	Rs.
	Consignment stock ...	
	Less Stock reserve ...	...

The consignment stock account and the consignment stock reserve account will be taken to the next year's books and then transferred to the consignment account.

NOTE:

The two entries regarding "unloading" are given at the beginning of this chapter.

ILLUSTRATION NO. 4

On 1st January 1994 Zubair & Co. of Karachi consigned 100 cases of dry milk to Tariq Agencies of Lahore. The goods were charged at a Performa Invoice value of Rs. 10,000 Iling a profit of 25 % on Invoice price. On the same date the consignors paid Rs. 600 for freight and Insurance. On 1st July, the consignees paid clearing charges Rs. 1,000, carriage Rs. 200. On 1st August, they sold 80 cases for Rs. 10,500 and sent a remittance for the balance due to the consignors after deducting commission at the rate of 5 % on gross sale proceeds. Show the Consignment Account and Tariq Agencies Account In Zubair & Co.'s Books.

Solution:

ZUBAIR & CO'S LEDGER

Consignment to Lahore Account

Dr. Cr.

Date	References		Amount Rs.	Date	References		Amount Rs.
1994				1994			
Jan. 1	Goods sent on Consignment		10,000	Jan. 1	Goods sent on Consignment (Loading)		2,500
	Bank: (Freight & Insurance)		600	Aug. 1	Tariq Agencies (Sales)		10,500
July 1	Tariq Agencies	Rs.			Stock out on consignment		
	Clearing charges	1000			Invoice price	2,000	
	Carriage	200			Exp. (1/5 of 1800)	360	2,360
	Commission	525	1,725				
	Stock Reserve (25 % of 2,000)		500				
	"Profit transferred to Profit & Loss A/c		2,535				
			15,360				15,360

TARIQ AGENCIES'S ACCOUNT

		Rs.			Rs.
1994			1994		
Aug. 1	Consignment to Lahore A/c	10,500	July 1	Consignment to Lahore A/c (Exp. and commission)	1,725
			Aug. 1	Bank A/c (Final Payment)	8,775
		10,500			10,500

WORKING NOTES:

		Rs.
(i)	Loading on goods sent on consignment 25 % on Rs. 10,000	2,500
(ii)	Loading on closing stock 25 % on Rs. 2,000	500
(iii)	Direct expenses included in valuation of closing stock 1/5 of Rs, 1,800	360

LOSS OF STOCK OR GOODS

Where part of the goods sent on consignment are damaged or lost in transit the treatment in the books of account will depend upon the nature of loss i.e. whether normal or abnormal.

NORMAL LOSS:

Loss of quantity of goods in the normal course of business and inherent and thus inevitable or unavoidable, such as loss because of loading or unloading of goods, leakage, evaporation or shrinkage, is known as ***normal loss.***

Treatment of normal loss is to charge it to the consignment account. The total cost of goods sent is charged to the units remaining. Value of stock is inflated to cover the normal loss or normal loss is absorbed by the remaining unit. For example, if 2000 Radio sets are consigned @ Rs. 300 per Radio set, freight being Rs. 10,000. Owing to normal loss only 1960 Radio sets are received by the consignee. If the quantity unsold at the end of the year is 500 Radio sets, the value of closing stock will be $\frac{6,00,000 + 10,000}{1960} \times 500$ or Rs. 155612 (APP). It will be a mistake to value the stock on the basis of $\frac{610000}{2000} \times 500$ or Rs. 152500. ***Being normal such a loss is a part of the cost of the consignment, so no separate entry is passed in the books of the consignor.*** Anyhow, such loss is considered while calculating the cost of stock left unsold with the consignee. The value of unsold stock on consignment is increased because the value of stock is the

proportion of the cost of the goods consigned and direct expenses that the quantity of stock bears to the total quantity of goods consigned as diminished by the normal loss of goods. In brief valuation of stock will be made;

$$\frac{\text{Original cost of goods consigned + Direct Expenses}}{\text{Total units of goods – units lost}} = \text{Adjusted per unit cost}$$

$$\text{Then ; Adjusted per unit cost} \times \text{unsold units} = \text{Value of unsold stock}$$

ILLUSTRATION NO. 5

Nawaz Sugar Mills Ltd. Gujrat consigned 200 bags of sugar to their agent Mr. Arshad at Peshawar. Each bag costing Rs. 300. They paid Rs. 1000 towards freight & insurance. During transit 2 bags were completely damaged and Mr. Arshad took the delivery of remaing consignment and immediately accepted a bill drawn on him for Rs. 20000 for two months. After two months, he reported that:

(a) 140 bags were sold @ Rs. 350.

(b) He had incurred the following expenses; Godown rent Rs. 1400, clearing charges Rs. 1800, carriage outwards Rs. 600.

He is entitled to a commission of 10 % on sales. Assuming that Mr. Arshad remits the balance by a bank draft, prepare necessary Accounts in books of the consignor.

Solution:

CONSIGNMENT TO ARSHAD ACCOUNT

Date	References	Amount Rs.	Date	References	Amount Rs.
	Goods sent on Consignment	60,000		Mr. Arshad (Sales)	49000
	Bank (Expenses)	1000		Stock on Consignment	18395.86
	Mr. Arshad (Expenses)	3800		Loss on consignment (Transferred to P & L A/c	2304.14
	Mr. Arshad (10 % commission on Rs.49000)	4900			
		69700			69700

MR. ARSHAD ACCOUNT

Date	References	Amount Rs.	Date	References	Amount Rs.
	Consignment A/c (Sales)	49000		B/R Account	20,000
				Consignment A/c	3800
				Consignment A/c (Commission)	4900
				Bank A/c	20300
		49000			49000

VALUATION OF STOCK:

Total quantity consigned .... 200 bags

Bags sold 140

Bags Lost (Normal) 2 142

Bags unsold 58

$$\frac{\textbf{Original cost of total goods + Direct Expenses}}{\textbf{Total quantity – quantity lost}} = \textbf{Adjusted per bag cost}$$

$$= \frac{60,000 + 2800}{200 \text{ bags} - 2 \text{ bags}} = \frac{62800}{198} = 317.17 \text{ (APP)}$$

Adjusted per bag cost = 317.17

Value of 58 bags = 317.17×58 = 18395.86 or 18396

ABNORMAL LOSS:

This type of loss is an avoidable loss because it does not arise due to the nature of the goods. Such loss may arise due to hard luck of the consignor (i.e. destruction of goods by fire, an accident or theft). Such losses are more or less abnormal and, in any case, do not occur frequently. This type of loss does not affect the value of goods and if part of the consignment has been lost in such a manner, one should debit the value of the goods lost to abnormal loss Account/Profit & Loss Account and credit the Consignment Account so that one may judge the profitability of the consignment properly. In case, if this loss is ignored like normal loss, the profit shown by the Consignment Account will be lower than what it would have been, had the loss not occurred. So, we let the consignment account show the same result as the loss had not taken place. On the preparation of the final accounts of the business (Trading & P & L A/c), this loss is finally shown on the debit side of P & L A/c being a loss of the business as a whole.

NOTE: The entries regarding abnormal loss are discussed at the start of the chapter.

ILLUSTRATION NO. 6

A of Haroonabad consigned goods costing Rs. 93,000 to B of Jehlum at Performa invoice price which is cost plus 20 % on cost. A paid insurance and other forwarding charges amounting to Rs. 7,510. B was allowed Rs. 1,500 per annum being the establishment cost; 5 % commission on gross sales and 3 % delcredere commission. He was also allowed 10 % of the net profit as extra commission after charging such commission. B paid Rs. 1,502 as landing charges. On 30th June 1994 the position was:

Three–fourth of the goods were sold at a profit of $33\frac{1}{2}$ % on cost–half of which were credit sales. One–sixth of the goods consigned were destroyed by fire and a claim lodged with the insurance company for Rs. 17,000. Insurance company admitted the claim for Rs. 15,000. Stock was valued at performa invoice price. Show the consignment account in the books of A. Goods were consigned on 1st January, 1994. A closes his books on 30th June every year.

Solution:

			Rs.			Rs.
1994				1994		
Jan. 1	Goods sent on consignment ...		1,11,600	June30	B's account	
	Bank (Insurance and forwarding charges)		7,510		Sales–cash	46,500
June 30	B's Account:				Sales–credit	46,500
	Establishment expenses	750			Insurance company	15,000
	Landing charges	1,502			Profit and Loss account (loss of stock not covered by the insurance company)	2,002
	Commission (5 %)	4,650			Stock on consignment	10,051
	Delcredere (commission 3%)	2,790			Goods sent on consignment (difference)	18,600
	Commission (10 % on net profit	755	10,447			
	Stock reserve account		1,550			
	Profit and loss account		7,546			
			1,38,653			1,38,653

NOTE:

(1) Value of Stock Lost:

Invoice price $\left(\frac{1}{6} \times 1,11,600\right)$ Rs. 18,600

Add expenses $\left(\frac{1}{6} \times 9,012\right)$ 1,502

20,102

Less: excess of invoice price over cost price 3,100 = Rs. 17,002.

This represents 'abnormal loss' therefore is to be credited to the consignment account. Out of which Rs. 15,000 worth claim has been admitted by the insurance company (debit the insurance company account) balance of loss Rs. 2,002 should be debited to profit and loss account.

(2) Stock on Consignment:

Invoice price $\left(\frac{1}{12} \times 1,11,600\right)$ = 9,300

Add expenses $\left(\frac{1}{12} \times 9,012\right)$ = 751

Rs. 10,051

(3) Delcredere commission, unless otherwise stated, should be calculated on total sales including cash sales.

(4) Commission of profit $= \frac{10}{110} \times 8,301 =$ Rs. 755 (app.)

ILLUSTRATION NO. 7

Dalda Vanaspaty Private Ltd. consigned 10,000 kg. of ghee costing Rs. 20 per kg. to Faiz & Co. of Lahore, on 1st January 1995. Dalda Vanaspaty Private Ltd. paid Rs. 50,000 as freight and insurance. 250 kg. of ghee were destroyed on 10.01.1995 in transit. The insurance claim settled at Rs. 4,500 and was paid directly to the consignors.

Faiz & Co. of Lahore took delivery of the consignment on 20th January 1995 and accepted a bill drawn upon them by Dalda Vanaspaty Private Ltd. for Rs. 1,00,000 for 3 months. On 31st March Faiz & Co. reported as follows:

(i) 7,500 kg. were sold at Rs. 30 per kg.

(ii) The other expenses were:

Godown rent Rs. 2,000: Salaries Rs. 20,000:

Printing and stationery including advertising Rs. 10,000.

(iii) 250 kg. were lost due to leakage.

Faiz & Co. are entitled to a commission of 4 $\frac{1}{2}$ % on all the sales affected by them. They paid the amount due in respect of consignment on 31st March.

Show the consignment account, the account of Faiz & Co. and the loss in transit account in the books of Dalda Vanaspaty Private Ltd. for the year ended 31st March 1995.

Solution:

BOOKS OF DALDA VANASPATY PRIVATE LTD.

Consignment to Lahore Account

			Rs.			Rs.
Jan. 1	Goods sent on consignment a/c		2,00,000	Jan. 10	Cash A/c (Insurance)	4500
	Bank–freight and insurance		50,000	Mar. 31	P & L account	1750
Mar. 31	Faiz & Co:				Faiz & Co. (sale)	225000
	Godown Rent	2,000			Stock on consignment A/c	51282
	Salaries	20,000			By Profit and Loss Account – Loss	9593
	Printing and stationery	10,000				
	Commission	10,125	42,125			
			2,92,125			2,92,125

LOSS IN TRANSIT ACCOUNT

		Rs.			Rs.
Jan. 10	Consignment account	6,250	Mar. 31	Cash A/c	4,500
				Profit and loss account	1,750
		6,250			6,250

FAIZ & CO.

		Rs.				Rs.
Mar. 31	Consignment Account	2,25,000	Jan. 20	Bills receivable account		1,00,000
			Mar. 1	Consignment account:		
				Godown rent	2,000	
				Salaries	20,000	
				Printing etc.	10,000	
				Commission	10,125	42,125
				Bank		82875
		2,25,000				2,25,000

NOTE:

(1) Value of Loss in Transit:

Cost Price of ghee damaged	$= 250 \text{ kg} \times \text{Rs. } 20$	=	Rs. 5000
Add: Consignor's proportionate Expenses	$= 50000 \times \frac{250}{10000}$	=	1250
Gross Loss		=	6250
Less: Insurance Claim		=	4500
Net Loss:		=	1750

(2) Value of Stock: $= \frac{200000 + 50000}{10000 - 250} \times (10{,}000 - 250 - 7500 - 250)$

$= \frac{250000}{9750} \times 2000$ = Rs. 51282 Approx

ILLUSTRATION NO. 8

(Abnormal loss in transit – damaged goods have no sale value). Baby Foods Co. Ltd. of Karachi sent to N.M. Stores Lahore 5000 kgs. of baby food packed in 2000 tins of net weight of 1 kg and 6000 packets of net weight of 1/2 kg for sale on consignment basis. The consignee's commission was fixed at 5 % of sales proceeds. The cost price and selling price of the product were as under:

	1 kg pack	**1/2 kg pack**
Cost price	**Rs. 10**	**Rs. 6**
Selling price	**Rs. 15**	**Rs. 7**

The consignment was booked on freight 'to pay' basis and freight charges come to 2 % of selling value. One case containing 50 1–kg. tins was lost in transit and the transport carrier admitted a claim of Rs. 450.

At the end of the first half year the following information is gathered from the 'Account Sales' sent by the consignee:

(i)	**Sale proceeds**	**1500 tins**	**1 kg tins**
		4000 tins	**1/2 kg packets**

(ii) Store Rent and Insurance charges Rs. 600.

Show the Consignment A/c and Consignee's Account in the books of Baby Milk Food Co. Ltd., assuming that the consignee had paid the amount due from them.

Solution:

BOOKS OF BABY FOOD LTD.
CONSIGNMENT ACCOUNT

		Rs.		Rs.
Goods sent on Consignment A/c:			N. M. Stores:	
2,000 1 kg tins @ Rs. 10	= 20,000		1500 kg tins @ Rs. 15	22,500
6000 1/2 kg Packets			4000 1/2 kg Packets @ Rs. 7	28,000
@ Rs. 6	= 36,000	56,000		
N. M. Stores:			Insurance (Claim)	450
Freight	1,440		P & L A/c (Abnormal loss)	65
Rent & Insurance	600		Consignment Stock A/c	16,915
Commission	2,525	4,565		
Profit and Loss A/c		7,365		
		67,930		67,930

N.M. STORES ACCOUNT

	Rs.			Rs.
Consignment A/c		Consignment A/c:		
(Sale proceeds)	50,500	Freight	1,440	
		Rent and Insurance	600	
		Commission	2,525	4,565
		Bank A/c		45,935
	50,500			50,500

WORKING NOTES:

(i) Cost of loss in transit (Abnormal):

50 1 kg tins @ Rs. 10	=	Rs. 500
Add freight 2 % of sales value $\frac{(50 \times 15 \times 2)}{100}$	=	Rs. 15
		Rs. 515
Less insurance claim:		Rs. 450
Net loss debited to P & L A/c	=	Rs. 65

(ii) Amount of freight:

Sale value of goods consigned

2000 1 kg tins @ 15	= Rs. 30,000
6000 1/2 kg Packets @ 7	= Rs. 42,000
	Rs. 72,000

2 % of 72,000 = Rs. 1,440

(iii) Value of Closing Stock:

450 1 kg tins @ Rs. 10	= Rs. 4,500
2000 1/2 kg Packets @ Rs. 6	= Rs. 12,000
	Rs. 16,500
Add Freight 2 % selling price	
450 × 15 = 6,750	
2000 × 7 = 14,000	
20,750	415
	Rs. 16,915

ILLUSTRATION NO. 9

(Abnormal loss in transit – sale of damaged goods)

Babar of Lahore consigned 100 bags of sugar, each bag costing Rs. 300 to his agent Mr. Liaqat at Kohat on 1st April 1993. He paid Rs. 500 towards freight and insurance. 15 bags were damaged in transit on 31st May, 1993. The consignor received Rs. 1000 as claim from Insurance company. Liaqat took delivery of the goods on 10th April, 1993 and immediately accepted a bill drawn on him for Rs. 20,000 for 60 days. On 30th June 1993, Consignee reported that:

(i) 70 bags were sold at Rs. 350 per bag.

(ii) The damaged bags were sold at Rs. 110 per bag.

(iii) He had incurred following expenses:

Godown Rent	**Rs. 700**
Clearing charges	**Rs. 1000**
Carriage outward	**Rs. 300**

Agent is entitled to a commission at 10 % on the sale proceeds of all goods excepting damaged goods. Mr. Liaqat remits the balance by bank draft on 30th June 1993. No portion of expenses incurred by Agent is attributable to the damaged bags. Prepare Consignment Account and Consignee's Account in the books of Babar.

Solution:

IN THE BOOKS OF BABAR
CONSIGNMENT ACCOUNT

Date	References	Amount Rs.	Date	References	Amount Rs.
1993			1993		
April 1	Goods sent on consignment A/c	30,000	May 31	Bank A/c (Insurance Claim)	1,000
	Cash A/c: (freight and insurance)	500	June 30	Liaqat (Sales)	
				70 × 350	24,500
June 30	Liaqat:			15 × 110	1,650
	Godown Rent	700		Profit & Loss A/c	
	Clearing charges	1,000		(Abnormal Loss)	1,925
	Carriage outward	300		Consignment stock A/c	4,751
	Commission	2,450		Profit & Loss A/c	1,124
		34,950			34,950

LIAQAT'S ACCOUNT

Date	References	Amount Rs.	Date	References	Amount Rs.
1993			1993		
June 30	Consignment A/c (Sales)	24,500	April 10	Bills Receivable A/c	20,000
	Consignment A/c		June 30	Consignment A/c:	
	(sale of damaged goods)	1,650		Godown Rent	700
				Clearing Charges	1,000
				Carriage outward	300
				Commission	2,450
				Bank A/c	1,700
		26,150			26,150

WORKING NOTES:

(i) Calculation of Loss of Damaged Goods:

Cost of damaged bags	
15×300	Rs. 4,500
Add Proportionate expenses	
incurred by consignor $\frac{(500 \times 15)}{100}$	Rs. 75
	Rs. 4,575
Less Insurance claim	Rs. 1,000
	Rs. 3,575
Less Sales proceeds (110×15)	Rs. 1,650
Net loss debited to P & L A/c	Rs. 1,925

(ii) Calculation of Closing Stock:

15 Bags @ Rs. 300	Rs. 4,500
Add Proportionate exp.	
incurred by Consignor $\frac{(500 \times 15)}{100}$	Rs. 75
Add Proportionate expenses by consignee	
$\frac{(1000 \times 15)}{85}$	Rs. 176
	Rs. 4,751

ILLUSTRATION NO. 10

(Consignment in two parts)

Omer consigned 40 machines to Usman on 1st January 1991 on the following terms:

(a) All machines were to be sold 20 % above cost of Rs. 10,000. Any deficit in selling price is to be borne by Usman while Usman is to retain 50 % of any surplus price realized.

(b) Usman is to be paid 3 % commission and 2 % delcredere commission on all sales.

Omer incurred freight charges of Rs. 40,000 in consigning the machines. Usman sent account sale on 31st December 1991 disclosing:

10 machines sold for Rs. 12,000 each.

5 machines sold for Rs. 10,000 each.

15 machines sold for Rs. 14,000 each.

Usman had incurred unloading charges of Rs. 4,000 and selling expenses of Rs. 6,000. He had collected the entire sale proceeds except Rs. 2,000 which had become a bad debt. Usman sent a bank draft for the net amount due to Omer.

On 30th June, 1992 Usman sent a further Account Sale disclosing:

10 machines sold at Rs. 12,000 each, selling expenses were Rs. 1,500. He also sent a draft for the net amount due.

Omer closes his books on 31st December each year.

Write up the ledger accounts in the books of Omer recording the above transactions.

Solution:

LEDGER OF OMER
CONSIGNMENT TO USMAN ACCOUNT

Date	References	Amount Rs.	Date	References	Amount Rs.
1991			1991		
Jan. 1	Goods sent on		Dec. 31	Usman (Sales)	3,80,000
	Consignment	4,00,000		Stock on Consignment	1,11,000
	Bank (freight)	40,000			
	Usman:				
	Unloading Charges	4,000			
	Selling Expenses	6,000			
	Commission	24,000			
	Profit & Loss A/c (Profit)	17,000			
		4,91,000			4,91,000
1992			1992		
Jan. 1	Consignment Stock	1,11,000	June 30	Usman (Sales)	1,20,000
	Usman:				
	Expenses (Selling)	1,500			
	Commission	6,000			
	Profit & Loss A/c (Profit)	1,500			
		1,20,000			1,20,000

USMAN ACCOUNT

Date	References	Amount Rs.	Date	References	Amount Rs.
1991					
Dec. 31	Consignment to Usman Account	3,80,000	Dec.31	Consignment to Usman Account	
				Expenses	10,000
				Commission	24,000
				Bank	3,46,000
		3,80,000			3,80,000
1992 June 30	Consignment to Usman A/c	1,20,000	June 30	Consignment to Usman A/c:	
				Expenses	1500
				Commission	6000
				Bank	1,12,500
		1,20,000			1,20,000

WORKING NOTES:

1. Calculation of Usman's Commission:

	Rs.
1991 5 % of sale proceeds Rs. 3,80,000	19,000
50 % of surplus realized on 15 machines	15,000
(Rs. 14,000 against Rs. 12,000, stipulated sale price)	34,000
Less short realization on 5 machines (Sale price Rs. 10,000 per machine against stipulated sale price of Rs. 12000)	10,000
	24,000
1992 5% of Rs. 1,20,000	6,000

2. Calculation of Closing Stock on 31.12.1991

Cost of 10 machines @ Rs. 10,000	=	Rs. 1,00,000
+ Proportionate Non–Recurring Expenses $\frac{(44,000 \times 10)}{40}$	=	Rs. 11,000
Total		Rs. 1,11,000

ILLUSTRATION NO. 11

(Dishonor of B/R)

P consigned to Q on 1st January 1996, 500 bales of cotton costing Rs. 100 per bale, Freight changes incurred in the consignment were Rs. 5,000. P drew a bill on Q for Rs. 50,000 payable on 30th June 1996 which Q accepted. The bill was discounted by P with his bankers on 31st January 1996 at 12 % p.a.

Q rendered Account Sales to P on 31st March 1996 showing sales of 300 bales for Rs. 80,000 and selling expenses of Rs. 5,000. Q's commission was 10 %. On this date Q remitted to P the net amount due to him.

On 31st May 1996 Q sold the balance stock for Rs. 30,000 after incurring expenses of Rs. 4000. He remitted Rs. 20,000 to P, the balance being treated as commission earned by him. On 30th June 1996 the bill accepted by Q was dishonored by him and the amount due to the bank was paid off by P along with incidental charges of Rs. 200.

Pass Journal Entries in the books of P (including bank transactions).

Solution:

IN THE BOOKS OF P
JOURNAL ENTRIES

Date	Details		L.F	Amount Dr.	Amount Cr.
1996	Consignment A/c	Dr.		50,000	
Jan. 1	Goods sent on consignment A/c				
	(Being 500 bales of cotton sent to Q on consignment				50,000
	@ Rs. 100 per bale)				
Jan. 1	Consignment A/c	Dr.		5,000	
	Bank				
	(Freight charges incurred on the consignment to Q				5,000
	Bills Receivable A/c	Dr.		50,000	
	Q A/c				50,000
	(Being acceptance received from Q for Rs. 50,000)				
Jan 31	Bank A/c	Dr.		47,500	
	Discount A/c	Dr.		2500	
	Bills Receivable A/c				50,000
	(Being bills receivable of Q discounted @ 12 %				
	p.a. for 5 months)				

March 31	Q A/c Dr.		80,000	
	Consignment A/c			80,000
	(Being 300 bales sold by Q)			
	Consignment A/c Dr.		13,000	
	Q A/c			13,000
	(Being expenses incurred by Q Rs. 5000, and commission payable to him, Rs. 8000)			
	Bank A/c Dr.		17,000	
	Q A/c			17,000
	(Being amount received from Q)			
May 31	Q A/c Dr.		30,000	
	Consignment A/c			30,000
	(Being 200 bales sent on consignment sold by Q)			
	Consignment A/c Dr.		10,000	
	Q A/c			10,000
	(Being expenses and commission payable to Q)			
	Bank A/c Dr.		20,000	
	Q A/c			20,000
	(Being amount received from Q in full settlement)			
June 30	Q A/c Dr.		50,200	
	Bank A/c			
	(Being bill accepted by Q dishonored; incidental charges of bank being Rs. 200)			50,200
	Consignment A/c Dr.		32,000	
	Profit & Loss			32,000
	(Being profit on consignment)			

NOTE:

(1) Since against Rs. 30,000, Q remits only Rs. 20,000 and his expenses are Rs. 4000, the balance must be treated as commission.

(2) Discount on B/R has been treated as finance charge, therefore, has not been debited to consignment A/c.

QUESTIONS

1. Define 'consignment'. Distinguish it from sales?
2. What is performa invoice? Why is it used in writing up the consignment account?
3. What is delcredere commission? Why it should be allowed by the consignor?
4. What is an account sales? Give one specimen.
5. Discuss fully the nature of relationship between consignor and the consignee.
6. How you will value unsold stock on consignment at the close of the year? Demarcate clearly between the expenses which are to be added up and expenses which are to be ignored.
7. What constitutes 'normal' and 'abnormal' loss of stock on consignment? Give, in detail, the accounting treatment for both the types of loss of stock.
8. In each of the following cases indicate the alternative which you consider to be correct:

(a) In accountancy 'consignment' signifies —

(i) goods forwarded from one place to another

(ii) goods forwarded by a person to another

(iii) goods dispatched by its owner to his agent

(iv) goods dispatched by its owner to his agent for the purpose of sale.

(b) Consignor is —

(i) principal

(ii) agent

(iii) debtor of the consignee

(c) Consignee is —

(i) principal

(ii) agent

(iii) none of these.

(d) Account sales is submitted by —

(i) consignee to the consignor

(ii) debtor to the creditor

(iii) principal to his agent.

(e) 'Goods sent on consignment' should be debited by consignor to —

(i) consignment account

(ii) goods sent on consignment account

(iii) consignors account.

(f) In the books of consignor the expenses incurred by the consignee should be debited to —

(i) consignment account

(ii) consignee's personal account

(iii) expenses account.

(g) In the books of consignor reporting of sale by consignee should be debited to —

(i) consignment account

(ii) consignor's account

(iii) consignee's personal account.

(h) In the books of consignor the acceptance of a bill of exchange by consignee will be credited to —

(i) consignee's account

(ii) bills receivable account

(iii) consignment account.

(i) In the books of consignor the profit on consignment should be debited to —

(i) profit and loss account

(ii) consignee's account

(iii) consignment account.

(j) In the books of consignor the loss on the consignment should be credited to —

(i) profit and loss account

(ii) Consignee's account

(iii) Consignment account.

(k) In the books of consignor the balance of the consignment stock account would be shown —

(i) as an asset in the balance sheet

(ii) as a liability in the balance sheet

(iii) on the credit side of the trading account.

(l) In the case of delcreder commission, the liability for bad debts is on —

(i) consignee

(ii) consignor

(iii) none of the above.

(m) In the books of consignor, the balance in the goods sent on consignment account is shown —

(i) on the assets side of the balance sheet

(ii) on the liabilities side of the balance sheet

(iii) on the credit side of trading account.

(n) In the books of consignor, the expenses incurred and paid by the consignor on account of cartage, freight, insurance etc. are debited to —

(i) freight and insurance account

(ii) particular consignment account

(iii) trade expenses account.

(o) In the books of consignee, on dispatch of goods by the consignor the entry would be —

(i) Consignment account Dr.

Goods sent on consignment account

(ii) Consignment account Dr.

Consignor

(iii) No entry.

(p) In the books of consignee the acceptance of a bill of exchange by consignee will be debited to —

(i) consignor's account

(ii) bills payable account

(iii) consignment account.

(q) In the books of consignee the expenses incurred by him on consignment are debited to —

(i) consignment account

(ii) cash account

(iii) consignor's account.

(r) In the books of consignee, the sale of goods is credited to —

(i) consignor's account

(ii) sales account

(iii) consignee's account.

Ans: [(a) (iv) (b) (i) (c) (ii) (d) (i) (e) (i) (f) (i)
(g) (iii) (h) (i) (i) (iii) (j) (iii) (k) (i) (l) (i)
(m) (iii) (n) (ii) (o) (iii) (p) (i) (q) (iii) (r) (i)]

PROBLEMS

1. Rauf & Co. of Lahore consigned to Farooq of Gujrat, 60 boxes of toys at Rs. 400 per box.

   The consignor paid carriage and insurance of Rs. 2,000. Farooq sent Rs. 10,000 as advance payment. Rauf & Co. received an Account Sales from Farooq containing the following particulars:

   (a) Gross sales proceeds are Rs. 34,000.

   (b) Transportation and warehousing charges are Rs. 1,500.

   (c) Commission at 15 % on gross proceeds.

   Rauf & Co. received bank remittance for the balance due from Farooq on the consignment. Pass the Journal entries and the necessary Ledger Accounts in the books of consignor and consignee.

Ans: *[Consignment Profit Rs. 1400]*

2. Karim & Co. of Karachi sent on consignment to Salman & Sons. of Lahore 60 cases of cutlery goods costing Rs. 175 per case. Expenses incurred by the consignor at Karachi are:

   Freight Rs. 275; Insurance Rs. 55; Loading Charges Rs. 20.

   Karim & Co. Draw on Salman & Sons. 2 months bill at sight for Rs. 7,000 which the latter accepts. The charges paid by Salman & Sons. at Lahore were: unloading charges Rs. 30; storage Rs. 85; Insurance Rs. 15. Commission is payable to Salman & Sons. at 2 % on all sales in addition to $1\frac{1}{2}$ % delcredere commission.

   The consignee sells for prompt cash 30 cases @ Rs. 225 per case; 25 cases @ Rs. 250 per case and the balance @ Rs. 280 per case. The account was settled immediately by means of a bank draft.

N.P. Write up the transactions and ledger accounts in the books of both the parties.

Ans: *[Profit on Consignment Rs. 2916]*

3. On Ist July 1991 P & Co. sends 300 cases of medicines to Zeeshan on consignment basis. The cost of each case was Rs. 1,000. P & Co. incurred the following expenses on the consignment: Rs. 750 on railway freight and Rs. 450 on insurance.

   200 cases were sold by Zeeshan uniformly at Rs. 2000 per case. Out of these 10 cases were sold to a party on credit and full amount ultimately proved bad. The expenses of Zeeshan amounted to Rs. 1,200. He sent an account sale on 31st December 1991 which revealed that he charged 5 % as ordinary commission and 10 % as delcreder commission. He sent a bank draft for Rs. 90,000.

   You are required to prepare Consignment Account, Zeeshan's Account and goods sent on consignment Account in the books of P & Co.

Ans: *[Profit on consignment Rs. 138000]*

4. Global Co. of Karachi sent 1,000 cases of Homeopathic medicines to Zahid & Bros. of Rawalpindi at Rs. 100 per case. Expenses on the Consignment incurred by the consignor amounted to Rs. 3,000. Zahid & Bros. in Rawalpindi were working as delcredere agents. Their commission is 5 % ; Delcredere Commission is 7 1/2 %.

   Exactly after six months an 'Account Sales' was received by Global Co. giving the following information:

   (a) Sale proceeds of 750 cases Rs. 1,50,000

   (b) Stock of unsold goods in hand, 250 cases

   (c) Commission charged at agreed rates of 5 % + 7 1/2 %

   (d) Consignee's expenses amounted to Rs. 1,200

   (e) A Bank draft for Rs. 1,00,000 was sent by Zahid Bros. along with the account sales.

   You are asked to give the necessary entries in the books of the consignor to record the above transactions.

Ans: *[Profit on Consignment Rs. 52,800]*

5. On 1st March 1994, Karim Bux consigned cloth to the value of Rs. 6,50,000 at cost to Afzal & Sons, his agent in Multan. Who accepted a 3 months draft for 80 % of the normal selling price. The draft was discounted at a cost of Rs. 13,000.

   Karim Bux paid Rs. 35,000 as freight and Rs. 6,500 as insurance on 30th September 1994, Afzal & Sons notified Karim Bux that 4/5th of the goods had been sold for Rs. 8,24,000 and that the selling expenses were Rs. 12,100.

   Karim Bux's normal selling price was cost plus 50 % and Afzal & Sons' were entitle to a commission at the rate of 10 % on normal selling price plus 25 % of any surplus price above normal.

   Show these transactions in the ledger of both the parties.

Ans: *[Consignment Profit Rs. 1,69,700]*

6. On 1st July 1994 Mr. M in Sialkot consigned to Mr. R in Swat, goods to the value of Rs. 75,000 (cost Rs. 60,000), paying freight charges Rs. 5,000 and draws a bill on Mr. R for Rs. 30,000. 3/4the of this consignment was sold by Mr. R for Rs. 70,000 and expenses Rs. 6,000 were incurred. Mr. R is also entitled to a commission of 6 % on sales. Mr. R remitted to Mr. M, the net amount held for his account by means of a sight draft. Show the ledger accounts in the books of Mr. M.

Ans. *[Profit on Consignment Rs. 11,050]*

7. On 1st January 1992 Mr. C of Lahore consigned to D of Sargodha goods for sale at invoice price. Mr. D is entitled to a commission of 5 % on invoice price and 10 % of any surplus price realized. Goods costing Rs. 24,000 were consigned to Sargodha at the invoice price of Rs. 28,000. The expenses of consignment amounted to Rs. 2,000. On 31st March 1992 an Account Sales was received from Mr. D showing that he had affected sales of Rs. 24,000 in respect of 3/4 of the quantity of goods consigned to him. The expenses incurred by him amounted to Rs. 1,200. Mr. D remitted the amount due by a bank draft.

Prepare consignment account, goods sent on consignment account and Mr. D's account in the Books of Mr. C and show the manner in which the Books would be closed on 31st March 1992.

Ans: *[Profit on Consignment Rs. 1,950]*

8. **On 1st January, 2001 Ahmad of Lahore consigned to Babar of Multan goods for sale at invoice price. Babar is entitled to commission of 5% on invoice price and 20% of any surplus price realized. Goods invoiced to Babar at Rs. 144,000 so as to give a profit of 20% on cost. The expenses of the consignment amounted to Rs. 7,500. On 31st March, 2001, an Account Sales was received from Babar showing that he had effected sales of Rs. 120,000 in respect of 2/3 of the quantity of goods consigned to him. His actual out of pocket expenses amounted to Rs. 8,400. Babar accepts a bill drawn by Ahmad for Rs. 40,000 and remitted the balance due from him in cash.**

Give consignment Account and Babar's account in the books of Ahmad.

Ans: *[Profit on Consignment Rs. 17,000]*

9. **Rizwan of Gujranwala sent 100 sewing machines to Aslam of Hong Kong at Rs. 650 (Rs.800 invoice price) per machine. The consignor paid Rs. 2,000 for packing and dispatching charges. Aslam, immediately after receiving the consignment accepted a bill for Rs. 40,000. After some time Aslam reported that 80 machines were sold for Rs. 875 each and expenses being on freight, Rs. 3,000, on godown rent, Rs. 250 and on insurance Rs. 500. Aslam is entitled to a commission of 9 % on sales. Due to insolvency of a customer who purchased 4 machines failed to pay anything. Another Customer reduced Rs. 250 due to the defects in the machines purchased.**

Show consignment Account, Aslam Account and goods sent on Consignment Account.

Ans: *[Profit on consignment Rs. 3200]*

10. **On 1st Jan. 1990 Razaq & Co. of Lahore consigned to Mushtaq & Co. of Mardan 100 cycles at Rs. 500 each which was 20 % above their cost price. Razaq & Co. had paid Rs. 200 for packing etc., Rs. 50 for insurance and Rs. 250 for carriage. On 1st March 1990, Mushtaq & Co. sold 75 cycles for Rs. 45,000, the expenses thereon being Rs. 2000. Mustaq & Co. are entitled for commission of 5 % and 2 % (delcredere) on sales and they remitted Rs. 30,000 on account. One customer who purchased 5 cycles failed to pay his debts due to his insolvency. Pass the necessary entries and prepare the necessary ledger accounts in books of Razaq & Co.**

Ans: *[Profit on consignment Rs. 8225]*

11. **Zaheer & Sons of Karachi dispatched a consignment of 400 cases of Electric bulbs to Hammad of Kohat on 1st December 1993. The invoice price was quoted at Rs. 1,80,000 so as to give a profit of 25 % on cost. On 25th December Hammad sent an account sales with the following details:**

(a) **75 % of the goods were sold.**

(b) **Hammad paid unloading changes Rs. 1200.**

(c) **Advertisement and selling expenses paid by Hammad amounted to Rs. 700.**

(d) **Hammad is to receive a commission of 5 % on sales.**

(e) **A bank draft was sent for the amount due.**

At the time of dispatch Zaheer & Sons incurred an expenditure of Rs. 2,000 towards freight and insurance charges.

Prepare necessary ledger accounts in the books of the consignor.

Ans: *[Profit on consignment Rs. 17150]*

12. Moon Textile Mills, Faisalabad consigned goods to Azam Traders in Lahore, to be sold at or above invoice price. Azam Traders is to get 10 % commission on sales at invoice price plus 20 % of any surplus realized. Moon Textile Mills draw on Azam Traders at 60 days sight for 80 % of the invoice price, the balance of the sale proceeds being remitted by bank draft by Azam Traders after deduction of their commission immediately upon sale.

During the year ended 31st March 1995 Moon Textile Mills, Faisalabad consigned to Azam Traders goods whose total cost including freight was Rs. 1,50,000. The invoice price of which was Rs. 2,25,000. Sales by Azam Traders during the year amounted to Rs. 2,05,000. Goods unsold on 31st March 1995 with Azam Traders were of the invoice price Rs. 67,500 (cost including freight Rs. 45,000). Moon Textile Mills had received from Azam Traders by bank draft the amount becoming due, leaving proportionate advance as balance with them.

Show the ledger accounts in the books of Moon Textile Mills, Faisalabad regarding the above transactions.

Ans: *[Profit on consignment Rs. 74750]*

13. **Normal Loss of Goods:** On 1st Jan. 1994, Mohsin Coal Co. of Quetta consigned to Ramzan Ltd. of Lahore 10,000 tons of coal. The cost of coal was Rs. 40 per ton and railway charges were Rs. 10 per ton. On 25th Feb., an Account sales was received From Ramzan Ltd. showing that 5000 tons of coal sold @ Rs. 80 per ton; sales expenses Rs. 4000, Insurance Rs. 1000, Brokerage 2 % and commission 3 % on sales. The agent enclosed a bill for the sales proceeds less expenses and reported a shortage of 100 tons on the whole consignment. Show the consignment account in books of Mohsin Coal Co.

Ans: *[Profit on consignment Rs. 122474.75]*

14. On 1st Jan. 1995 Saleem Corp. of Lahore sent 100 coloured T.V. sets to Furqan of Faisalabad at a cost of Rs. 13000 per T.V. set. They paid carriage Rs. 5,000, insurance Rs. 3000 and octroi duty Rs. 1000. Furqan received the consignment and unloading charges amounted to Rs. 1000 were paid. On 28th Feb. 1995, Furqan sent an Account Sale showing that; 80 T.V. sets sold @ Rs. 16000 per T.V. set, selling expenses incurred Rs. 4000, godown rent Rs. 1500, commission @ 4 % and delcredere commission 1 % on sales. He also reported that 2 T.V. sets were completely damaged at the time of unloading. One of the customers who had purchased two T.V. sets on credit became insolvent and only 50 % recovery was made from him. Pass the entries and prepare consignment account in the books of Saleem Corp.

Ans: *[Profit on consignment Rs. 141112.22]*

15. **Abnormal Loss:** M/s Naeem Motors sent 100 cars to Haseeb on consignment. The cost of each car was Rs. 12,000 but was invoiced to Haseeb at cost plus 25 %. The expenses of M/s Naeem Motors were:

Freight Rs. 7,000, Insurance Rs. 3,000.

During transit one car was destroyed and the insurance company admitted Rs. 9000 towards that claim.

Haseeb sold 7 cars at Rs. 15,000 each and paid for storage and insurance Rs. 3,400. Haseeb then accepted a bill for Rs. 90,000 at 3 months drawn by M/s Naeem Motors which they discounted immediately with their bank at 6 % p.a. It was agreed that Haseeb is to get 5 % commission.

Give the consignment account in the books of M/s Naeem Motors.

Ans: *[Profit on consignment Rs. 11650, Abnormal Loss Rs. 3100]*

16. Bilal of Lahore consigned 100 cases of candles to Abdullah of Mardan which cost him Rs. 50 per case. He incurred the following costs: packing Rs. 100; carriage Rs. 150 and Railway freight Rs. 200. Some of the cases were damaged in transit and Abdullah took delivery of 90 cases only. Abdullah spent Rs. 50 for cartage and Rs. 300 for godown rent and sold the consignment at Rs. 60 per case. He sent the net amount to Bilal after deducting his expenses and commission at the rate of 5 % on the sale proceeds together with his Account Sales. Bilal also received Rs. 300 from the Railway as damages. Show how the transactions would appear in books of Bilal.

Ans: *[Loss on consignment Rs. 125, Abnormal Loss Rs. 245]*

17. 1000 bicycles were consigned by Sohrab & Co., Ltd. of Lahore to A & Co. of Colombo at an invoice cost of Rs. 500 each. Sohrab & Co. Ltd. paid freight Rs. 10,000 and insurance Rs. 2,000. During the voyage 100 bicycles were totally damaged by fire and had to be thrown overboard. A & Co. took delivery of the remaining bicycles and paid Rs. 15,000 as customs duty.

A & Co. had sent a bank draft of Rs. 3,00,000 to Sohrab & Co. Ltd as advance payment and later sent an account sales showing that 800 bicycles were sold at Rs. 750 each. Expenses incurred by A & Co. on godown rent and advertisement, etc. amounted to Rs. 3,000. A & Co. are entitled to a commission of 5 %. One of the credit customers could not pay the cost of 5 bicycles.

Prepare the consignment account, A & Co. Account and Profit and Loss Account in the books of Sohrab & Co. Ltd., assuming that nothing has been recovered from the insurance company due to a defect in the policy. A & Co. settled their account immediately.

Ans: *[Profit on consignment Rs. 1,40,317]*

18. Dilawar consigned 5,000 Kgs of Vanaspati Ghee to Sarwar. Each Kg. Vanaspati Ghee costs Rs. 8. Dilawar paid Rs. 50 as carriage, Rs. 250 as freight and Rs. 200 as insurance. During transit 500 Kgs of Vanaspati Ghee was accidentally spoiled for which the insurance company paid directly to the consignor, Rs. 2,500 in full settlement of the claim.

After three months from the date of the consignment, Sarwar reported that 3,500 Kgs. of Vanaspati Ghee was sold at Rs. 9.50 per Kg. and expenses being on ground rent, Rs. 500 and on salesman's salary, Rs. 750. Sarwar is entitled to a commission of 5 % on sales. Sarwar also reported a loss of 20 Kgs. of Vanaspati Ghee due to leakage.

Prepare the necessary accounts in the books of Dilawar.

Ans: *[Profit on consignment Rs. 1857]*

19. A of Lahore consigned 500 radio sets costing Rs. 1000 each to B of Sialkot on 1st March, 2001. The expenses on consignment were freight Rs, 5000 insurance Rs. 2,500, carriage Rs. 500.

B received the delivery of 470 radio sets. An account sale dated 30th June, 2001 showed that 395 sets were sold for Rs. 750,000 and B incurred Rs. 2,350 for carriage Rs. 6,000 for godown rent. B was entitled to a commission @ 6% on sales. B incurred expenses amounting to Rs. 2,800 for repairing the damaged radio sets remaining in the stock.

Mr. A lodged a claim with insurance company which was admitted at 75% of cost price.

Show the necessary accounts in the Books of A.

Ans: *[Profit on Consignment Rs. 2,92,905]*

20. A Jute Mill at Jaranwala sends regular consignment of Jute goods to Messrs. Riaz & Co. of Lahore who are agents for selling the Jute goods at the risk of the Mill and are entitled to a commission of 15 paise per Kg of Jute goods sold (This includes delcredere commission).

Stock of Jute goods with the agent at the beginning — 20,000 Kgs costing Rs. 50,000.

Total quantity of Jute goods consigned 1,60,000 Kgs at Rs. 4 per Kg.

Total quantity of Jute goods sold 1,50,000 Kgs at Rs. 5 per Kg.

Total remittances by the agent Rs. 6,00,000.

Railway freight paid by the agents Rs. 40,000.

Of the sales Messrs. Riaz & Co. of Lahore could not collect Rs. 15,000 due to insolvency of a customer. 5,000 Kgs of Jute goods were damaged in Railway transit for which the agents recovered Rs. 8,000. The damaged goods were sold at the rate of Rs. 2 per Kg. Record the above transactions in the books of the Jute Mill at Jaranwala and find out the profit or loss if any.

Ans: *[Profit on consignment Rs. 124250]*

21. On 1st October, 1994 Mr. Sohail of Karachi sent 200 units of a product to Mr. Arif of Lahore. The goods were invoiced at Rs. 150 so as to yield a profit of 50 % on cost. Mr. Sohail incurred Rs. 2000 on freight and insurance. Mr. Arif incurred Rs. 1000 on freight and Rs. 1600 on rent. Up to 31st Dec., 1994, he sold 100 units for cash at Rs. 160 per unit and 40 units for Rs. 175 on credit. He charged his commission 6 % (including delcredere) and remitted the balance on 31st Dec., 1994 and reported that 20 units were damaged on account of bad packing and he could sell them only for Rs. 80 per unit. One of the customers to whom goods of Rs. 1000 were sold on credit failed to pay his debts due to insolvency. Make necessary ledger accounts in the books of Mr. Sohail assuming that the accounting year ends on 31st December every year.

Ans: *[Profit on consignment Rs. 3920]*

CHAPTER - 19

PARTNERSHIP ACCOUNTS

PARTNERSHIP ACCOUNTS I PROFIT DISTRIBUTION AND ADMISSION OF A PARTNER

ESSENTIALS OF PARTNERSHIP

The law governing partnership is contained in the Partnership Act, 1932. Section 4 of the Act defines partnership as "the relation between persons who have agreed to share the profits of a business carried on by all or any of them acting for all".

The following are the essential elements of partnership:

1. There must be an agreement entered into by all the persons concerned.
2. The agreement must be to share the profits of a business.
3. The business must be carried on by all or any of them acting for all.

All these elements must be present before a partnership can come into existence. If any of them is not present, there cannot be formed a partnership.

PARTNERSHIP AGREEMENT

Partnership is the result of an agreement. The agreement among the partners which sets out the terms on which they have agreed to form a partnership is called partnership agreement. It may be in writing or by words of mouth or be implied from the course of conduct of the parties. It is desirable to have the partnership agreement in writing to avoid future disputes. The document in writing containing the various terms and conditions as to the relationship of the partners to each other is called the 'partnership deed'. The following clauses are normally included in partnership agreement.

1. Name under which business of the firm is to be carried on.
2. Nature of partnership business.
3. The capital of the firm and the proportion in which it is to be contributed by each partner.
4. Ratio in which profits and losses are to be shared by partners.
5. Rate at which interest is to be allowed on the capital and charged on the drawings.
6. Amount which each partner is allowed to withdraw in anticipation of profits from the business for private expenses and the timing of such drawings.
7. Amount of salaries and other allowances if any payable to partners.

8. Commencement and duration of partnership.
9. Whether the capital accounts are to be fixed or fluctuating.
10. Valuation of goodwill at the time of retirement or death of a partner.
11. The method of ascertaining the amount due to the retiring partner or the representative of a deceased partner at the time of retirement or death and the manner in which the amount due will be paid.
12. Keeping of proper books of accounts and preparation of balance sheet.
13. Audit of the accounts of the firm and the manner of appointment of auditor.
14. Right and duties of partners.
15. Arbitration clause, laying down the procedure to be followed for the settlement of disputes among the partners.

The mutual rights and liabilities of partners are contained normally in a partnership agreement. But where there is no agreement, the provisions contained in sections 12 to 17 of the Partnership Act will apply.

RIGHTS OF THE PARTNERS

1. Every partner has a right to take part in the conduct and management of the business.
2. Every partner has a right to be consulted and heard in all matters affecting the business of partnership.
3. Every partner has the right to have access to and to inspect and copy any one of the books of the firm.
4. The partners are entitled to share equally in the profits earned and shall contribute equally to the losses sustained by the firm.
5. A partner making for the purpose of the business any payment or advance beyond the amount of the capital he has agreed to subscribe, is entitled to interest thereon at the rate of six per cent per annum.
6. Every partner has a right to be indemnified by the firm in respect of payments made and liabilities incurred by him in the ordinary and proper conduct of the business and in doing such an act in an emergency for the purpose of protecting the firm from loss as would be done by a person of ordinary prudence in his own case under similar circumstances.
7. A partner has the right not to allow the admission of a new partner.

DUTIES OF THE PARTNERS

1. Every partner is bound to attend diligently to his duties in the conduct of the business.
2. A partner is not entitled to receive any remuneration for taking part in the conduct of the business.
3. A partner shall indemnify the firm for any loss caused to it by his willful neglect in the conduct of the business of the firm.

4. A partner shall be liable to account for and pay to the firm any private profits derived from the transactions of the firm or from the use of the property of goodwill of the firm.

5. If a partner carries on any business of the same nature as and competing with that of the firm, he is bound to account for and pay to the firm all profits made by him in that business.

RULES APPLICABLE IN THE ABSENCE OF AN AGREEMENT

In the absence of an agreement to the contrary, the following rules are applicable:

1. The partners shall share equally the profits and losses.
2. A partners shall be entitled to interest at the rate of six per cent per annum on the loan advanced by him to the firm.
3. A partner is not entitled to any salary for taking part in the conduct of the business.
4. No partner is entitled to interest on the capital.
5. No interest on drawing is to be charged by the firm.

ILLUSTRATION NO. 1

A, B and C commenced business in partnership on 1st January, 1992 without any agreement. Capital was introduced as follows:

A – Rs. 50,000; B – 30,000; C – 20,000.

On 1st July 1992, C advanced Rs. 10,000 by way of loan to the firm.

The profits for the year ended 31st December 1992 amounted to Rs. 13,800 but the partners cannot agree upon the question of interest upon capital or loan and upon the basis of division of profits. The matter is, therefore, referred to you. How would you divide the profits for the year?

Solution:

In the absence of an agreement, no interest shall be allowed on capital, 6 per cent interest per annum will be allowed on the loan advanced and profits and losses shall be shared equally.

Dr. **PROFIT AND LOSS APPROPRIATION ACCOUNT** Cr.

		Rs.		*Rs.*
Interest on loan @ 6 %			Balance b/d	13,800
for six months		300		
Net profit transferred to				
capital accounts:				
A	4,500			
B	4,500			
C	4,500	13,500		
		13,800		13,800

DISTRIBUTION OF PROFITS

In the case of a sole trader, the net profit as disclosed by the profit and loss account belongs to the proprietor and is transferred to his capital account. However, in the case of a partnership concern, the net profit is to be shared by all the partners in the agreed profit sharing ratio. For this purpose, the net profit in the case of a partnership concern is transferred to an account called profit and loss appropriation account. This account is merely an extension of the profit and loss account and is prepared to show how the net profit has been distributed among he partners. The account is credited with the net profit or debited with net loss to begin with. The account is further credited with the interest on drawings and debited with interest on capital, salary or commission payable to partners. After these adjustments have been made, the profit or loss appropriation account will show the amount of net profit or net loss which shall be distributed among the partners in the agreed profit sharing ratio.

The following journal entries are passed for distribution of profits among partners.

1. ***For interest on capital***

   Profit and loss appropriation account Dr.

   Partners capital accounts

2. ***For salary or commission payable to partners***

   Profit and loss appropriation account Dr.

   Partners capital accounts

3. ***For interest on drawings***

   Partners capital accounts Dr.

   Profit and loss appropriation account

4. ***For distribution of profit***

   Profit and loss appropriation account Dr.

   Partners capital accounts

In case of loss, however, the above entry will be reversed.

ILLUSTRATION NO. 2

A, B and C set up a partnership firm on 1.1.1992. They contributed Rs. 50,000, Rs. 40,000 and Rs. 30,000 respectively as their capitals and decided to share profit and loss in the ratio of 3 : 2 : 1. The partnership deed provided that A is to be paid a salary of Rs. 1,000 per month and B a commission of Rs. 5,000. It also provided that interest on capital be allowed at 6 % per annum. The drawings for the year were A Rs. 6,000, B Rs. 4,000 and C Rs. 2,000. Interest on drawings was charged Rs. 270 on A's drawings Rs. 180 on B's drawings and Rs. 90 on C's drawings. The net amount of profit as per profit and loss account for the year 1992 was Rs. 35,660.

You are required to pass the necessary journal entries relating to the appropriation of profit and prepare the profit and loss appropriation account and the partner's capital accounts.

Solution:

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	Profit and loss appropriation account Dr.		*Rs.*	*Rs.*
	A's capital account		12,000	
	(Being the amount of salary allowed to A)			12,000
	Profit and loss appropriation account Dr.		5,000	
	B's capital account			5,000
	(Being the amount of commission payable to B)			
	Profit and loss appropriation account Dr.		7,200	
	A's capital account			3,000
	B's capital account			2,400
	C's capital account			1,800
	(Being the interest on capital allowed)			
	A's capital account Dr.		270	
	B's capital account Dr.		180	
	C's capital account Dr.		90	
	Profit and loss appropriation account			540
	(Being interest on drawings charged)			
	Profit and loss appropriation account Dr.		12,000	
	A's capital account			6,000
	B's capital account			4,000
	C's capital account			2,000
	(Being the amount of profit on appropriation)			

PROFIT AND LOSS APPROPRIATION ACCOUNT

		Rs.			Rs.
A's salary		12,000	Net profit as per		
B's commission		5,000	profit and loss account b/d		33,660
Interest on capital			Interest on drawings		
A's capital	3,000		A's capital	270	
B's capital	2,400		B's capital	180	
C's capital	1,800	7,200	C's capital	90	540
Capital account–share of profit					
A's capital	6,000				
B's capital	4,000				
C's capital	2,000	12,000			
		36,200			36,200

A'S CAPITAL ACCOUNT

	Rs.		Rs.
Drawings	6,000	Cash	50,000
Interest on drawings	270	Salary (P & L App. A/c)	12,000
Balance b/d	64,730	Interest on capital (P&L App.A/c)	3,000
		Profit and loss account	
		— share of profit	6,000
	71,000		71,000

B'S CAPITAL ACCOUNT

	Rs.		Rs.
Drawings	4,000	Cash	40,000
Interest on drawings	180	Commission (P & L App. A/c)	5,000
Balance b/d	47,220	Interest on capital (P&L App.A/c)	2,400
		Profit and loss account	
		— share of profit	4,000
	51,400		51,400

C'S CAPITAL ACCOUNT

	Rs.		Rs.
Drawings	2,000	Cash	30,000
Interest on drawings	90	Interest on capital (P&L App.A/c)	1,800
Balance c/d	31,710	Profit and loss account	
		— share of profit	2,000
	33,800		33,800

INTEREST ON CAPITAL

If interest on capital is to be allowed, provision to this effect must be contained in the partnership deed. In the absence of any such provision no interest on capital can be claimed by any partner as a matter of right.

Interest on capital is always calculated with reference to the time it remains in the business. It is calculated on the figure at the commencement of the period and allowance is made for the addition of capital or withdrawals there from during the period, interest beings worked out from the dates thereof. The amount of interest is debited to interest on capital account and is credited to the capital account of the partner concerned.

INTEREST ON DRAWINGS

Interest on drawings is also charged like interest on capital, if it is provided in the partnership agreement. Since drawing are effected by partners often in irregular amounts and on varying dates, it is considered advisable to calculate interest on drawings to adjust the rights of partners. It many cases, however, drawings are made by mutual agreement and no interest is charged at all.

Where interest is charged it is usually calculated at fixed rate percent from the date of each drawing to the date the accounts are closed. If the dates on which the amounts are drawn is not given interest is calculated on the whole amount on the assumption that the money was drawn eventtly throughout the year. The amount of interest is debited to partners drawings accounts and is credited to the interest on drawings account. At the close of the accounting period the interest on drawings account is closed by transfer to the profit and loss account.

It may, however, be noted that if the withdrawals are of uniform amount and are made at regular intervals, then interest on drawings can be calculated on the total of the amount drawn, for the average of the periods applicable to first and last installment. Therefore, if drawings are made at the beginning of each month, interest should be calculated on the whole amount for $6\frac{1}{2}$ months. If drawings are made at the end of each month, interest should be calculated on whole amount for $5\frac{1}{2}$ months. If drawings are made at the middle of each month, interest should be calculated on the whole amount for 6 months.

ILLUSTRATION NO. 3

A partner's capital on 1st January, 1992 was Rs. 50,000. On 1st October, 1992 he introduced a further Rs. 10,000 into the business. During the year he withdrew Rs. 500 at the end of each month. Interest @ 6 % is to be allowed on the capital and charged on the drawings. The books are balanced on 31st December each year. Calculate the amount of interest on the capital and drawings and pass the necessary journal entries.

Solution:

Calculation of interest on capital:

Interest on Rs. 50,000 for one year @ 6 %	Rs.	3,000
Interest on Rs. 10,000 for 3 months @ 6 %	Rs.	150
$\left(10{,}000 \times \frac{3}{12} \times \frac{6}{100}\right)$	Rs.	3,150

Interest on drawings	**Months**		**Products**
Rs. 500 drawn on 31st Jan.	11		5,500
Rs. 500 drawn on 28th Feb.	10		5,000
Rs. 500 drawn on 31st March	9		4,500
Rs. 500 drawn on 30th April	8		4,000
Rs. 500 drawn on 31st May	7		3,500
Rs. 500 drawn on 30th June	6		3,000
Rs. 500 drawn on 31st July	5		2,500
Rs. 500 drawn on 31st Aug.	4		2,000
Rs. 500 drawn on 30th Sep.	3		1,500
Rs. 500 drawn on 31st Oct.	2		1,000
Rs. 500 drawn on 30th Nov.	1		500
Rs. 500 drawn on 31st Dec.	×		—
		Total product	33,000

Interest on drawings on Rs. 33,000 for one month @ 6 %

$$= \quad 33{,}000 \times \frac{1}{12} \times \frac{6}{100} = \text{Rs. } 165$$

Journal Entries:

1.	Interest on capital account	Dr.	3,150	
	Partners capital account			3,150
2.	Partners capital/drawings account	Dr.	165	
	Interest on drawings account			165

FIXED AND FLUCTUATING CAPITALS

In partnership accounts partners capital accounts can be maintained in two different ways, namely capitals may be considered to be fluctuating or fixed quantities. When the capitals of the partners are fluctuating, all adjustments with regard to the interest on capital, interest on drawings, profit and loss, partners salaries and drawings are made through the capital accounts. The capital account of a partner is credited with the share of the profit, interest on capital, partners salary while it is debited with the net loss (if any) drawings and interest on drawings. As a result of these adjustments the capital of the partner at the end is different from it is at the commencement of the period.

The capital account under the fluctuating capital system will appear as under.

PARTNERS CAPITAL ACCOUNT

	Rs.		*Rs.*
Drawings		Balance b/d	
Interest on drawings		Interest on capital	
Profit and loss account		Salary	
(Share of loss in case of loss)		Commission	
Balance c/d		Profit and loss account	
		(Share of profit in case of profit)	

Sometimes it is provided that the capital of the partners shall be fixed and shall be maintained at the same figure during the partnership. In such a case the capital of the partners is credited with the actual contribution of the partner towards his capital and balanced at the same figure from year to year. No adjustment is passed through the capital account in such a case. In such a case, in addition to the capital account, a current account in the name of each partner is opened. The current account is credited with interest on capital, share of profits and the salary to which he is entitled. This account is debited with the drawings of the partners, interest on drawings and also with the share of loss (if any). Current account is a personal account and will be shown either on the asset or liability side of the balance sheet according to its balance. It appears in the balance sheet quite distinct from the capital account. A credit balance in the current account after all the adjustments indicate that the partner has not withdrawn the whole of profits and the interest due to him. A debit balance on the other hand would indicate that the partner has drawn in excess of his share of profits and interest to the extent of such balance. The advantage of this method of maintaining the capital accounts is that the capitals remain intact.

The capital accounts and the current accounts of the partners will appear as follows when the capitals are fixed.

PARTNERS CAPITAL ACCOUNT

	Rs.		Rs.
Balance c/d	—	Balanced b/d	—
	—	Balance b/d	—

PARTNERS CURRENT ACCOUNT

	Rs.		Rs.
Drawings		Balance b/d	—
Interest on drawings		Interest on capital	—
Profit and loss account		Salary	
(Share of loss in case of loss)		Commission	
		Profit and loss account	
		(Share of profit in case of profit)	

ILLUSTRATION NO. 4

On 1st January, 1993 A and B enter into partnership contributing Rs. 200,000 and Rs. 150,000 respectively and sharing profits in the ratio of 3 : 2. B is to be allowed a salary of Rs. 5,000 per year. Interest on capital is to be allowed at 10 % per annum, 5 % interest is to be charged on the drawings. During the year A withdrew Rs. 6,000 and B Rs. 10,000, interest being A Rs. 100 and B Rs. 200. Profit in 1993 before making any of the above adjustments was Rs. 48,000. Show how the profit is to be distributed. Also show the capital accounts (a) if they are fixed (b) if they are fluctuating.

Solution:

PROFIT AND LOSS APPROPRIATION ACCOUNT
for the year ending 31st December, 1993

		Rs.			Rs.
Salary to B		5,000	Balance b/d		48,000
Interest on capital			Interest on drawings		
A	20,000		A	100	
B	15,000		B	200	300
Capital/Current A/c					
A	4,980				
B	3,320	8,300			
		48,300			48,300

(i) *When capitals are fixed*

A'S CAPITAL ACCOUNT

	Rs.		Rs.
Balance c/d	200,000	Cash A/c.	200,000

B'S CAPITAL ACCOUNT

	Rs.		Rs.
Balance c/d	150,000	Cash A/c.	150,000

A'S CURRENT ACCOUNT

	Rs.		Rs.
Drawings	6,000	Interest on capital	20,000
Interest on drawings	100	Profit and loss account	4,980
Balance c/d	18,880		
	24,980		24,980

B'S CURRENT ACCOUNT

	Rs.		Rs.
Drawings	10,000	Salary	5,000
Interest on drawings	200	Interest on capital	15,000
Balance c/d	13,120	Profit and loss account	3,320
	22,320		23,320

(ii) *Where capitals are fluctuating*

A'S CAPITAL ACCOUNT

	Rs.		Rs.
Drawings	6,000	Cash	200,000
Interest on drawings	100	Interest on capital	20,000
Balance c/d	18,880	Profit and loss account	4,980
	224,980		224,980

B'S CURRENT ACCOUNT

	Rs.		Rs.
Drawings	10,000	Cash	150,000
Interest on drawings	200	Salary	5,000
Balance c/d	163,120	Interest on capital	15,000
		Profit and loss account	3,320
	173,320		173,320

CALCULATION OF CAPITAL RATIO

Sometimes the partners agree to share the profit in the ratio of their capital contribution. If the capitals of the partners are fixed, profits would be divided in the fixed capital ratio. However, if the capitals of the partners are fluctuating, then the drawings and the additions to the capital must be taken into consideration to determine the capital ratio. The weighted average with reference to time has to be worked out to determine the ratio in which profit or loss will be shared.

ILLUSTRATION NO. 5

A and B entered into partnership on 1st January 1992 contributing Rs. 15,000 and Rs. 10,000. A invested Rs. 6,000 as additional capital on 1st May whereas B brought additional capital of Rs. 4,000 on 1st October. They earned a profit of Rs. 6,600 during the year. Profits are to be shared in their capital ratio. Calculate partners share of profit and pass the necessary journal entry.

Solution:

A's contribution for one month

15,000 × 12	=	180,000
6,000 × 8	=	48,000
		228,000

B's contribution for one month

10,000 × 12	=	120,000
4,000 × 3	=	12,000
		1,32,000

Capital ratio between A and B will be 2,28,000 : 1,32,000 or 228 : 132 or 57: 33 or 19:11

$$\text{A's share of profit} = 6{,}600 \times \frac{19}{30} = 4{,}180$$

$$\text{B's share of profit} = 6{,}600 \times \frac{11}{30} = 2{,}420$$

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	Profit and loss account Dr.		6,600	
	A's capital account			4,180
	B's capital account			2,420
	(Being profit transferred to A's and B's capital accounts in the capital ratio)			

GOODWILL

Goodwill may be defined as the benefit and the advantage of the good name or reputation of a business. It enables a concern to earn more profits on the capital employed by attracting more customers than in comparable organizations. The following are some of the definitions of goodwill:

'Goodwill of a business is the advantage, whatever it may be which a person gets by continuing to carry on and being entitled to represent to the outside world that he is carrying on a business, which has been carried on for some time previously'.

Goodwill is a thing very easy to describe, very difficult to define. It is the benefit or advantage of the good name, reputation or connection of a business. It is the attractive force which brings in customers'.

From the accountants view point, goodwill, in the sense of attracting customers has little significance unless it is valuable in the sense of having a saleable value. To the accountant, therefore, goodwill is an intangible but not a fictitious asset. The goodwill possessed by a firm may be due to the following factors:

(a) The personal reputation of the partners.

(b) The reputation of the goods dealt in.

(c) Location of the business premises.

(d) Advantage available in regard to the supply of the materials etc.

(e) Possession of favorable contracts complete or partial monopoly etc.

(f) Possession of contented and efficient employees.

(g) Possession of trade marks, patents or well known business name.

(h) Continuance of advertising campaigns.

(i) The maintenance of quality of the firms products and development of business With changing conditions.

(j) Freedom from legislative restrictions.

The necessity of valuation of goodwill arises in the following cases:

(a) Upon the introduction of a new partner.

(b) Upon the retirement or death of a partner.

(c) Upon the dissolution or sale of firm's business.

(d) Upon the amalgamation of two business.

(e) Upon an agreed change in the profit sharing ratio.

METHODS OF VALUATION OF GOODWILL

No accurate formula can be laid down for the measurement of the value of goodwill. The value of goodwill depends upon the nature of a particular business and the circumstances connected with it.

Various methods are advocated for the valuation of goodwill. In many cases the method adopted is a purely arbitrary one and is often governed by the custom of the particular trade in which the business is engaged. The more usual bases of valuation are as follows:

1. *Average profits method*

The average profits of given number of a past years multiplied by an agreed number is considered to be the value of goodwill. Thus 'three years' purchase of average profits of the last few years is commonly spoken of as the basis upon which goodwill is to be valued. The average profits of a given number of past years is multiplied by an agreed number of years to arrive at the value of goodwill. This method is purely arbitrary and will frequently produce a figure for goodwill out of all proportions to its true value.

Suppose the goodwill is to be valued on 3 years purchase of the average profits of the last five years. The profits earned during the last five years are Rs. 13,000, Rs. 10,000, Rs.12,000, Rs. 15,000 and Rs. 20,000. The goodwill be valued as follows:

Year		Profit (Rs.)
1st year		13,000
2nd year		10,000
3rd year		12,000
4th year		15,000
5th year		20,000
	Total profits	70,000

Average profits: $70{,}000 \div 5 = $ Rs. 14,000

$\therefore$ Value of goodwill (being three years purchase of the average net profits for five years) $= 14{,}000 \times 3 = 42{,}000$.

2. *Super profits method*

Super profits of a business are the profits which can be expected in the future over and above those necessary to pay a fair return upon the capital invested in the business, having regard to the risk involved in that particular business and a fair remuneration for the services of the partners who work therein. Super profits is the excess of actual profits over normal profits. The normal profits are calculated by multiplying the average capital employed with the rate of general expectation. The super profits thus calculated is multiplied by an agreed figure to find out the value of goodwill.

Suppose a firm earned net profits during the last five years as follows:

1st year	2nd year	3rd year	4th year	5th year
Rs. 7,000	Rs. 6,500	Rs. 8,000	Rs. 7,500	Rs. 6,000

If the capital investments of the firm is Rs. 40,000 and a fair return on capital having regard to the risk involved is 10 %, the value of goodwill if based on three years purchase of the average super profits of the last five years will be calculated as follows:

Total profit earned during five years	=	Rs. 35,000
Average annual profits Rs. 35,000 ÷ 5	=	Rs. 7,000
Normal profits (10 % of Rs. 40,000)	=	Rs. 4,000
Super profit = Rs. 7,000 – Rs. 4,000	=	Rs. 3,000

Value of goodwill (being 3 years purchase of the average super profits) = 3,000 × 3 = Rs. 9,000.

The steps involved in the valuation of goodwill according to this method are as follows:

(i) Calculation of average profits.

(ii) Calculation of normal profit on capital employed on the basis of normal return of return.

(iii) Calculation of super profits by deducting the normal profits from average profits and

(iv) Calculation of goodwill by multiplying the super profits by the given number of years purchase.

I. *Capitalization method*

In this method, the whole value of business is calculated by capitalization the average or actual profits by the following formula:

$$\frac{\text{Actual profits}}{\text{Normal rate of return}} \times 100$$

The net assets of the firm are deducted from the value of business as calculated above to find out the value of goodwill.

Suppose a firm earns a net profit of 7,500 annually and the firm normally earns a profit of 10 %, the total value of the firm will be Rs. 75,000 i.e. Rs. 7,500 × $\frac{100}{10}$ = Rs. 75,000. If, however, the net tangible assets of the business amount to Rs. 50,000, the goodwill be valued at Rs. 75,000 – Rs. 50,000 i.e. Rs. 25,000. However, there will be no goodwill if the net tangible assets exceed or equal the total value of the business.

This method of valuation of goodwill involves the following steps:

(i) Find out the average profits.

(ii) Capitalize the average profits on the basis of the normal rate of return. This will give total value of business.

(iii) Compute the actual capital employed by deducting the outside liabilities form total assets (excluding goodwill)

(iv) Compute the value of goodwill by deducting net assets from the total value of business.

CHANGE IN PROFIT SHARING RATIO

Sometimes the partners decide to change their existing profit sharing ratio. The change will result in either increase or decrease or no change in share of individual partner. The partner in such a case who stands to gain must compensate the other partner who has suffered a loss. The compensation is in the form of proportionate share of goodwill which the gaining partner must pay to the other. Suppose A and B are two partners sharing the profits and losses in the ratio of 5 : 3. They decide that in future they will share th profits in the ratio of 3 : 1. If the goodwill of the firm is valued at Rs. 20,000 then A must pay B Rs. 2,5 $\left(\frac{1}{8} \times \text{Rs. } 20{,}000\right)$ for $\frac{1}{8}$ the share of profit which he has acquired from B.

In this case the entries to be passed are to raise goodwill account at full value and credit is given the capital accounts of the partners in the old profit sharing ratio. Goodwill account thus raised is written of to the capital accounts of the partners in the new profit sharing ratio.

ILLUSTRATION NO. 6

A and B have been carrying on the business sharing profits and losses in the ratio of 3 : 1. It is agreed that with effect from 1st January 1994 B is to have 2/5th share in the future profits and for that profits, such goodwill to be valued on the basis of two years purchase of the average of the past three years profits. The profits for the year 1991, 1992 and 1993 were Rs. 13,000, Rs. 18,000 and Rs. 14,000. Make the necessary journal entries.

Solution:

Value of goodwill

Profit for	1991	13,000
	1992	18,000
	1993	14,000

$$\text{Average profits} = \frac{45{,}000}{3} = 15{,}000$$

Goodwill at two years purchase $2 \times 15{,}000 = 30{,}000$

$$\text{B's gain} = \frac{2}{5} - \frac{1}{4} = \frac{8-5}{20} = \frac{3}{20}$$

$\therefore$ B must pay A $30{,}000 \times \frac{3}{20} = 4{,}500$ on account of goodwill.

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				Rs.	Rs.
	Goodwill account	Dr.		30,000	
	A's capital account				22,500
	B's capital account				7,500
	(Being goodwill raised and credited to partners in old profit sharing ratio)				
	A's capital account	Dr.		18,000	
	B's capital account	Dr.		12,000	
	Goodwill account				30,000
	(Goodwill written off in new profit sharing ratio)				

The above two entries can be merged together in the form of a single entry as follows:

				Rs.	Rs.
	B's capital account	Dr.		4,500	
	A's capital account				4,500
	(Being the amount of goodwill payable by B to A on account of the change in the profit sharing ratio. B gaining $\frac{2}{5} - \frac{1}{3}$ i.e. $\frac{3}{20}$ share from A)				

PARTNERSHIP ACCOUNTS — ADMISSION OF A PARTNER

In case additional capital or managerial hand or both are required in the course of expansion of a business, it becomes usual to admit a new person into the business as a partner. If the existing business is owned by a sole trader, it is converted into a partnership concern on the admission of the new partner. A new partner in an already existing partnership can be admitted with the consent of all the partners. The most important adjustments necessitated by the admission of a partner into partnership are:

1. Calculation of new profit sharing ratio.
2. Goodwill and its treatment in accounts.
3. Revaluation of assets and liabilities of the firm.
4. Adjustment regarding accumulated reserves.
5. Adjustment of capital accounts of the old partners.

ADMISSION OF A NEW PARTNER

When a new partner is admitted, legally it is the end of the old partnership and the beginning of a new one. Partners may, however, continue the business under a revised agreement and may decide to continue the use of its accounting books also. In such a situation, no record is made of the liquidation (end) of the old partnership or of the starting of a new partnership. Rather, the admission of the new partner is treated as a special event and recorded appropriately.

CALCULATION OF NEW PROFIT SHARING RATIO

The calculation of the new profit sharing ratio depends upon the agreement between the old and the new partners. The following cases will clearly explain the calculation of the new profit sharing ratio.

CASE I: *If the share of the new partner is stated then the presumption is that the old partners will continue to share the remaining profit in the old profit sharing ratio.*

ILLUSTRATION NO. 7

A, B and C are partners sharing profits in the ratio of $\frac{5}{12}:\frac{1}{3}:\frac{1}{4}$. They admit D for $\frac{1}{8}$ share. Find out the new profit sharing ratio.

Solution:

Old ratio $= \frac{5}{12}:\frac{1}{3}:\frac{1}{4}$ (given)

D's share $= \frac{1}{8}$ (given)

Combined share of A, B and C in the new firm $= 1 - \frac{1}{8} = \frac{7}{8}$

A's share in the new firm $= \frac{5}{12} \times \frac{7}{8} = \frac{35}{96}$

B's share in the new firm $= \frac{1}{3} \times \frac{7}{8} = \frac{7}{24}$

C's share in the new firm $= \frac{1}{4} \times \frac{7}{8} = \frac{7}{32}$

D's share $= \frac{1}{8}$

New profit sharing ratio $= \frac{35}{96} : \frac{7}{24} : \frac{7}{32} : \frac{1}{8}$

$$= \frac{35 : 28 : 21 : 12}{96}$$

$$= 35 : 28 : 21 : 12$$

CASE II: ***In some cases, new partner purchases his share from the other partners in a certain ratio. In that case the share of the old partners will be calculated by deducting the proportion which they have surrendered in favor of the new partner.***

ILLUSTRATION NO. 8

A and B are partners sharing profits and losses in the ratio of 3 : 2. They admit C into partnership giving him 1/5 share in profits which he acquires from A and B in the ratio of 2 : 1. Calculate the new profit sharing ratio.

Solution:

C acquires his share of profit $\left(\frac{1}{5}\right)$ from A and B in the ratio of 2 : 1. This means that he gets $\left(\frac{1}{5} \times \frac{2}{3}\right)$ i.e., $\frac{2}{15}$ from A and $\left(\frac{1}{5} \times \frac{1}{3}\right)$ i.e. $\frac{1}{15}$ from B.

Hence A's share $= \frac{3}{5} - \frac{2}{15} = \frac{9-2}{15} = \frac{7}{15}$

B's share $= \frac{2}{5} - \frac{1}{15} = \frac{6-1}{15} = \frac{5}{15}$

Thus new profit sharing ratio for A, B and C will be $\frac{7}{15} : \frac{5}{15} : \frac{3}{15}$ or 7 : 5 : 3.

CASE III: ***In some cases, the old partner surrenders a fraction of his share in favor of a new partner. In such cases what has been surrendered must first be calculated and then the same must be deducted from the share of the old partners to find his new share. New partner's share, however, will be calculated by the sum total of all that has been surrendered by all the old partners.***

ILLUSTRATION NO. 9

A and B are partners sharing profits and losses in the ratio of 3 : 2. C was admitted as a partner. A surrendered 1/3rd of his share and B surrendered $\frac{1}{2}$ of his share in favor of C. Calculate the new profit sharing ratio.

Solution:

A's old share = $\frac{3}{5}$

A's surrendered $\frac{1}{3}$ rd of $\frac{3}{5}$ in favor C i.e., $\frac{1}{3} \times \frac{3}{5} = \frac{1}{5}$

A's new share $\frac{3}{5} - \frac{1}{5} = \frac{2}{5}$

B's old share $\frac{2}{5}$

B surrenders $\frac{1}{2}$ of $\frac{2}{5}$ in favor of C i.e. $\frac{1}{2} \times \frac{2}{5} = \frac{1}{5}$

∴ B's new share $= \frac{2}{5} - \frac{1}{5} = \frac{1}{5}$

C's share is the sum total of the share surrendered by A and B

$= \frac{1}{5} + \frac{1}{5} = \frac{2}{5}$

∴ New profit sharing ratio $\frac{2}{5} : \frac{1}{5} : \frac{2}{5}$ or 2 : 1 : 2.

ILLUSTRATION NO. 10

A and B are partners in a firm sharing profits and losses in the ratio of 3 : 2. C is admitted into partnership with 1/4 share in profit which he acquires wholly from A. Determine the new profit sharing ratio of the partners.

Solution:

C acquires his share of profit $\left(\frac{1}{4}\right)$ wholly from A.

Hence A's new share $= \frac{3}{5} - \frac{1}{4} = \frac{12-5}{20} = \frac{7}{20}$

B's share= $\frac{2}{5}$ or $\frac{8}{20}$

C's share= $\frac{1}{4}$ or $\frac{5}{20}$

Thus the new profit sharing ratio between A, B and C will be $\frac{7}{20} : \frac{8}{20}$ and $\frac{5}{20}$ or 7:8:5.

CALCULATION OF SACRIFICE RATIO

One the admission of a partner in a firm, loss is suffered by the old partners. The old partners may sacrifice either in their old profit sharing ratio or in some other ratio. Sacrifice made by the old partners can be found out by deducting their new share from the old share.

CASE I: ***If in addition to the old ratio of the old partners, the new ratio of the incoming partners is given, then in the absence of the details of the sacrifice made by the old partners the normal presumption is that the loss is suffered by the old partners in the old profit sharing ratio.***

ILLUSTRATION NO. 11

A and B are partners sharing the profits in the ratio 5 : 3. C is admitted into the partnership with 1/4 share of future profits. Calculate the new profit sharing ratio and the sacrifice ratio.

Solution: C's share= $\frac{1}{4}$

Remaining profit $1 - \frac{1}{4} = \frac{3}{4}$

A's share is $\frac{5}{8}$ of $\frac{3}{4}$ or $\frac{5}{8} \times \frac{3}{4} = \frac{15}{32}$

B's share is $\frac{3}{8}$ of $\frac{3}{4}$ or $\frac{3}{8} \times \frac{3}{4} = \frac{9}{32}$

C's share is $\frac{1}{4}$ or $\frac{8}{32}$

$\therefore$ New profit sharing ratio is $\frac{15}{32} : \frac{9}{32} : \frac{8}{32}$ or 15 : 9 : 8.

Sacrifice= Old ratio – New ratio

A's sacrifice $= \frac{5}{8} - \frac{15}{32} = \frac{20-15}{32} = \frac{5}{32}$

B' sacrifice $= \frac{3}{8} - \frac{9}{32} = \frac{12-9}{32} = \frac{3}{32}$

$\therefore$ Sacrifice made by A and B is also in the ratio of 5 : 3.

Note: It may be noted that where the old ratio and the new ratio of the old partners does not change, the sacrifice of the old partners would also be in the old profit sharing ratio.

Sometimes, at the time of admitting a new partner, old partners re-arrange their shares in profits in such a way that some of the existing partners may also gain additional share in profits. In such a situation the existing gaining partner or partners will also be required to compensate the partner who makes the sacrifice. Hence it may involve the calculation of both gain and sacrifice.

ILLUSTRATION NO. 12

A and B are partners who share the profits in the ratio of 2 : 1. They admit C into partnership and the profit sharing ratio of the partners is agreed at 2 : 2 : 1 respectively. Calculate the gain or sacrifice of the old partners.

Solution:

Sacrifice/gain by old partners.

A

His new share in profits $\left(\frac{2}{5}\right)$ is less than his old share in profits. This means that he has sacrificed a part of his share.

Sacrifice = Old share – New share

$$= \frac{2}{3} - \frac{2}{5} = \frac{10-6}{15} = \frac{4}{15}$$

B

His new share in profits $\left(\frac{2}{5}\right)$ is more than his old share in profits $\left(\frac{1}{3}\right)$. This means he has gained some share in profits under the new arrangement

Gain = New share – Old share

$$= \frac{2}{5} - \frac{1}{3} = \frac{6-5}{15} = \frac{1}{15}$$

Thus A has sacrificed $\frac{4}{15}$ of his share in profits. Of this B gets $\frac{1}{15}$ and C gets $\frac{3}{15}\left(\text{or } \frac{1}{5}\right)$.

GOODWILL ON ADMISSION

The treatment of Goodwill, when a person is admitted into the partnership will depend upon as to whether goodwill account exists or does not exist at the time when the new person is admitted into the partnership concern.

(A) WHERE GOODWILL DOES NOT EXIST IN THE BOOKS OF ACCOUNT

The different methods for the treatment of goodwill in this case are:

I. PREMIUM METHOD

(a) The amount of goodwill is paid privately by the incoming partner to the old partners.

(b) The value of goodwill attributable to incoming partner's share of profit is brought in cash and the amount is retained in the business.

(c) The value of goodwill attributable to incoming partner's share of profit is brought in cash and the amount is withdrawn by the old partners.

II. REVALUATION METHOD

The incoming partner does not bring in the amount of goodwill in cash, but a goodwill account is raised in the books at full value.

III. MEMORANDUM REVALUATION METHOD

Incoming partner does not bring in the amount of goodwill in cash, a goodwill account is raised in the books at full value and is then immediately written off.

The various methods are discussed as under:

1. PREMIUM METHOD

(a) Incoming partner brings in the goodwill in cash. It is paid by the incoming partner to the old partners privately in the ratio of their sacrifice. No entries are passed in the books of the firm in this case.

(b) The amount of goodwill proportionate to the incoming partners share of profit is brought in by him in cash and it is retained in the business. The following journal entries are passed under this method:

(i) Debit bank account

Credit goodwill account

(Being the amount of goodwill brought in by the incoming partner)

(ii) Debit goodwill account

Credit old partners capital accounts

(Being the amount of goodwill credited to old partners capital accounts in the sacrificed ratio)

It may be noted that credit will be given to the capital accounts of the old partners in the ratio of loss suffered by them on the admission of the new partner in the partnership concern. If on admission loss is suffered by one of the partners, the entire amount of goodwill will be credited to him. But if on admission loss is suffered by the old partners either in the old profit sharing ratio or in some other ratio goodwill be credited to the capital accounts of the old partners in the same proportion.

ILLUSTRATION NO. 13

A and B are partners sharing profits and losses in the ratio of 3 : 1. C is admitted into the partnership with 1/4th share in the future profits which he takes entirely from A. C bring in Rs. 10,000 on account of capital and Rs. 6,000 on account of goodwill. Pass journal entries.

Solution:

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			Rs.	Rs.
	Bank account Dr.		16,000	
	C's capital account			10,000
	Goodwill account			6,000
	(Being the amount brought in by C on account of goodwill and capital)			
	Goodwill account Dr.		6,000	
	A's capital account			6,000
	(Being the amount of goodwill credited to A's capital)			

NOTE: Since the loss of C admission is suffered by A alone, therefore the amount brought in by C as goodwill is transferred to A's capital account.

ILLUSTRATION NO. 14

A and B share profits and losses in the ratio of 5 : 3. They admit C into partnership. C brings in Rs. 20,000 as capital and Rs. 6,000 as goodwill. The new profit sharing ratio is 7 : 4 : 3. Make journal entries.

Solution:

We know that the amount brought in by the incoming partner on account of goodwill is shared by the old partners in the ratio of their sacrifice.

$$\therefore \quad \text{A's loss} = \frac{5}{8} - \frac{7}{14} = \frac{35-28}{56} = \frac{7}{56}$$

$$\text{B's loss} = \frac{3}{8} - \frac{4}{14} = \frac{21-16}{56} = \frac{5}{56}$$

$\therefore$ Goodwill be shared by A and B in the ratio of 7 : 5.

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			Rs.	Rs.
	Bank account Dr.		26,000	
	C's capital account			20,000
	Goodwill account			6,000
	(Being the amount brought in by C as capital and goodwill)			
	Goodwill account Dr.		6,000	
	A's capital account			3,500
	B's capital account			2,500
	(Being the amount of goodwill credited to A's and B's capital in the ratio of their sacrifice i.e. 7 : 5)			

It may be noted that there is an alternative method for the treatment of goodwill which is now increasingly becoming popular. Under this method, the whole amount brought in by the incoming partner on account of his capital and share of goodwill is credited to his capital account. An account is raised in the books of the old firm for the full value of goodwill and the capital accounts of the old partners are credited in the proportions in which they share the profits and losses. The goodwill account thus raised is written off to the capital accounts of all the partners including the incoming partner in the new profit sharing ratio.

The entries for the above illustration in this case would appear as under.

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				Rs.	Rs.
	Goodwill account	Dr.		28,000	
	A's capital account				17,500
	B's capital account				10,500
	(Goodwill raised at full value and credited to the capital accounts of the old partners in the old profit sharing ratio)				
	Bank account	Dr.		26,000	
	C's capital account				26,000
	(Being the amount brought in by C as capital and goodwill)				
	A's capital account	Dr.		14,000	
	B's capital account	Dr.		8,000	
	C's capital account	Dr.		6,000	
	Goodwill account				28,000
	(Goodwill written off to all the partners in the new profit sharing ratio)				

Net effect of these entries is that A gets a credit of Rs. 17,500 – Rs. 14,000 i.e. Rs. 3,500. B gets a credit of Rs. 10,500 – Rs. 8,000 i.e. Rs. 2,500, while C gets a debit of Rs. 6,000.

(c) The amount of goodwill proportionate to the incoming partners share of goodwill is brought in by him in cash and it is withdrawn by the old partners. This method is similar to the method discussed above with the exception that the money paid by the incoming partner for goodwill is allowed to be withdrawn by the old partners, (i.e. It is not left in the business as additional working capital). In such a case in addition to the entries passed above an additional entry for the withdrawal of cash by the partners will have to be passed. The additional entry will be:

Debit old partners capital accounts

Credit bank account

It may, however, be noted that the old partners may withdraw the amount either in part or in full. In such a case debit to partners capital accounts will be with the exact amount withdrawn.

ILLUSTRATION NO. 15

A and B are partners in a firm sharing profits and losses in the ratio of 5 : 3. C is admitted in the firm for 1/5th share of profits. He is to bring in Rs. 30,000 as capital and Rs. 8,000 as his share of Goodwill. Give necessary journal entries

(a) when the amount of Goodwill is retained in the business.

(b) when the amount of Goodwill is fully withdrawn.

(c) when 50 % of the amount of Goodwill is withdrawn.

Solution:

(a) When the amount of goodwill is retained in the business.

				Rs.	Rs.
	(i) Cash account	Dr.		38,000	
	C's Capital account				30,000
	Goodwill account				8,000
	(Being the amount brought in by C as his capital and goodwill)				
	Goodwill account	Dr.		8,000	
	A's capital account				5,000
	B's capital account				3,000
	(Goodwill transferred to A's and B's capital in the ratio of 5 : 3)				

(b) When the amount of goodwill is fully withdrawn

				Rs.	Rs.
	In addition to above two entries, the following entry is passed.				
	A's capital account	Dr.		5,000	
	B's capital account	Dr.		3,000	
	Cash account				8,000
	(Being the cash withdrawn by A and B equal to their share of Goodwill)				

(c) When 50 % of the amount of Goodwill is withdrawn

			Rs.	Rs.
	A's capital account Dr.		2,500	
	B's capital account Dr.		1,500	
	Cash account			4,000
	(Being the cash withdrawn for 50 % of their share of goodwill)			

2. REVALUATION METHOD

(Goodwill Raised in Books of Accounts)

When the incoming partner is not in a position to bring the amount of goodwill in cash, then a Goodwill account is raised in the books of the firm ***at full value, and credit is given to the capital accounts of the old partners in their old profit sharing ratio.*** The journal entry necessary in this case would be

Debit goodwill account

Credit old partners capital accounts

Since the Goodwill indicates a debit balance it will be shown on the assets side of the balance sheet of the new firm.

ILLUSTRATION NO. 16

A and B are partners sharing profits and losses in the ratio of 3 : 2. They admit C into the partnership with a 1/4 share in the future profits. C bring in Rs. 20,000 on account of capital but is unable to bring in anything on account of goodwill. Goodwill of the firm is valued at two years purchase of the average profits of the last three years. The profits of the last three years were Rs. 8,000,
Rs. 10,500 and Rs. 11,500. Make journal entries.

Solution:

Value of goodwill

Total profits of the last three years 30,000

$\therefore$ Average profit $= \dfrac{30,000}{3} = 10,000$

$\therefore$ Value of goodwill $= 10,000 \times 2 = 20,000$

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			Rs.	Rs.
	Bank account Dr.		20,000	
	C's capital account			20,000
	(Being the amount brought in by C as his capital)			
	Goodwill account Dr.		20,000	
	A's capital account			12,000
	B's capital account			8,000
	(Value of goodwill credited to A and B in the ratio of 3 : 2)			

3. MEMORANDUM REVALUATION METHOD

When the incoming partner is not in a position to bring in the amount of goodwill in cash, then a Goodwill account is raised in the books of concern at full value and is credited to the capital accounts of old partners in the old profit sharing ratio and when Goodwill is written off, credit is given to the Goodwill account and capital account of all the partners are debited (including the incoming partner) in the new profit sharing ratio. Goodwill account in this case will not appear if it is desired to write off the Goodwill account. The necessary journal entry would be.

A's capital account	Dr.	9,000	
B's capital account	Dr.	6,000	
C's capital account	Dr.	5,000	
Goodwill account			20,000
(Goodwill written off in new profit sharing ratio)			

ILLUSTRATION NO. 17

A and B are partners sharing profits and losses in the ratio of 3 : 1. C is admitted into the partnership concern with a fifth share in the future profits. His share of goodwill is Rs. 10,000. Give journal entries regarding goodwill in all cases except when goodwill is paid privately by the incoming partner.

Solution:

CASE (a) When the incoming partner brings in the amount of goodwill in cash and it is retained in the business.

				Rs.	*Rs.*
	Cash account	Dr.		10,000	
	Goodwill account				10,000
	(Being the amount of goodwill brought in by C)				
	Goodwill account	Dr.		10,000	
	A's capital account				7,500
	B's capital account				2,500
	(Being goodwill transferred to old partners in the sacrifice ratio)				

CASE (b) When the incoming partner brings in the amount of goodwill in cash and the old partners withdraw the same. In this case in addition to the two entries passed above the following additional entry is passed.

				Rs.	*Rs.*
	A's capital account	Dr.		7,500	
	B's capital account	Dr.		2,500	
	Cash account				10,000
	(Being the amount of goodwill withdrawn by the partners)				

CASE (c) When goodwill account is raised in the books.

				Rs.	Rs.
	Goodwill account	Dr.		50,000	
	A's capital account				37,500
	B's capital account				12,500
	(Being goodwill raised in the books at full value and credited to old partners in the old profit sharing ratio)				

CASE (d) When goodwill account is raised in the books and is immediately written off.

				Rs.	Rs.
	Goodwill account	Dr.		50,000	
	A's capital account				37,500
	B's capital account				12,500
	(Being goodwill raised in the books at full value)				
	A's capital account	Dr.		30,000	
	B's capital account	Dr.		10,000	
	C's capital account	Dr.		10,000	
	Goodwill account				50,000
	(Being goodwill account written off in the new profit sharing ratio)				

ILLUSTRATION NO. 18

A and B are partners sharing profits in the ratio of 3 : 2. They admit C into the partnership, C paying a premium of Rs. 1,000 for 1/4th share of profit. The new ratio is 3 : 3 : 2. Goodwill account appears in the books at Rs. 1,000. It was decided that Goodwill should continue to appear in the books at Rs. 800. Give journal entries to record the above.

Solution:

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Date	Details			Dr. Amount	Cr. Amount
				Rs.	Rs.
(i)	A's capital account	Dr.		600	
	B's capital account	Dr.		400	
	Goodwill account				1,000
	(Being the amount of old goodwill written off in the old profit sharing ratio)				

(ii)	Cash account	Dr.	1,000	
	C's capital account			1,000
	(Being the amount brought in by C as his share of goodwill)			
(iii)	C's capital account	Dr.	1,000	
	A's capital account			900
	B's capital account			100
	(Being the amount of goodwill brought in by C credited to the capital accounts of the old partners in the sacrifice ratio i.e. 9 : 1)			
(iv)	Goodwill account	Dr.	800	
	A's capital account			300
	B's capital account			300
	C's capital account			200
	(Being the amount required to be shown in the balance sheet for goodwill raised in the new profit sharing ratio i.e. 3 : 3 : 2)			

ALTERNATIVE METHOD

			Rs.	Rs.
(i)	Goodwill account	Dr.	3,000	
	A's capital account			1,800
	B's capital account			1,200
	(Being goodwill account raised to its full value i.e. Rs. 4,000 in the old ratio as the goodwill already appears in the books i.e. at Rs. 1,000)			
(ii)	A's capital account	Dr.	1,200	
	B's capital account	Dr.	1,200	
	C's capital account	Dr.	800	
	Goodwill account			3,200
	(Being the goodwill written off by Rs. 3,200 in the new ratio so as to leave Rs. 800 in the books)			
(iii)	Cash account	Dr.	1,000	
	C's capital account			1,000
	(Being the amount brought in by C as goodwill credited to his capital account)			

(B) WHERE GOODWILL ACCOUNT ALREADY EXISTS IN THE BOOKS OF ACCOUNT

Where goodwill account already exists in the books of account, the following alternative may be considered:

(i) If the goodwill account already exists in the books of the old firm at the full value, the incoming partner will not be required to pay anything for goodwill. Any cash brought in by the new partner for a share of goodwill will be credited to his capital account.

(ii) If the goodwill appears in the books at less than the full value, the goodwill may be written up to its full value by crediting the old partners in the old profit sharing ratio with their shares of amount by which the goodwill is written up. Any sum paid in by new partner by way of capital and goodwill will be credited to his capital account.

Let us suppose A and B are partners sharing profits and losses in the ratio of 3 : 1. They admit C into the partnership concern with a 1/4th share in the future profits. C brings into the business Rs. 20,000 on account of capital. Goodwill account already appears in the books at Rs. 20,000. The new value of goodwill at the time of C's admission is estimated at Rs. 40,000. This means that at the time of C's admission goodwill account should be debited with another Rs. 20,000 and credit will be given to the capital accounts of the old partners in the old profit share ratio. The necessary journal entry would be:

Goodwill account	Dr.	20,000	
A's capital account			15,000
B's capital account			5,000

If the goodwill appears in the books of the old firm at a value higher than the true value, the excess should be written off to the capital accounts of the old partners in their old profit sharing ratio. For instance if the goodwill account appears in the books at Rs. 40,000 and the value of goodwill estimated on C's admission is Rs. 20,000 then the loss of Rs. 20,000 would be written off to the capital accounts of the old partners in the old profit sharing ratio. The necessary journal entry would be:

A's capital account	Dr.	15,000	
B's capital account	Dr.	5,000	
Goodwill account			20,000

ILLUSTRATION NO. 19

A and B are partners sharing profits in the ratio of 3 : 2. C is admitted into the partnership concern with a 1/4th share in future profits. C brings in Rs. 20,000 on account of capital. Goodwill of the firm is to be valued at three years purchase of the average profits of the last five years. The profits of the last 5 years are Rs. 10,000, Rs. 9,000, Rs. 8,000, Rs. 12,000 and Rs. 11,000. Give journal entries if, (a) Goodwill account does not appears in the books. (b) If goodwill account appears in the books at Rs. 18,000 and (c) the goodwill account appears in the books at Rs. 50,000.

Solution:

Valuation of goodwill:

Total profits of five years: 10,000 + 9,000 + 8,000 + 12,000 + 11,000= 50,000

Average profits= $\frac{50,000}{5}$ = 10,000

Value of goodwill at three years purchase of the average profits = 3 × 10,000 = 30,000

The entry for the capital introduced by C would be the same in all the cases.

			Rs.	Rs.
	Cash Account Dr.		20,000	
	C's capital account			20,000
	(Being the amount brought in by C as his capital)			

The entry for goodwill in various cases will be as under:

CASE (a) When goodwill account does not appear in the books.

			Rs.	Rs.
	Goodwill account Dr.		30,000	
	A's capital account			18,000
	B's capital account			12,000
	(Being the goodwill account raised in the books and credited to capital accounts of A and B. the ratio of 3 : 2)			

CASE (b) When goodwill account appears in the books at Rs. 18,000.

			Rs.	Rs.
	Goodwill account Dr.		12,000	
	A's capital account			7,200
	B's capital account			4,800
	(Being goodwill account raised at Rs. 12,000 and credited to A and B's capital in the ratio 3 : 2)			

CASE (c) Where goodwill account appears in the books at 50,000.

			Rs.	Rs.
	A's capital account Dr.		12,000	
	B's capital account Dr.		8,000	
	Goodwill account			20,000
	(Being Rs. 20,000 goodwill written off to A's and B's capital in the ratio of 3 : 2)			

ILLUSTRATION NO. 20

A and B are partners in a firm sharing profits and looses in the ratio 3 : 2. They decide to admit C into partnership with 1/3 share in profits, C brings in Rs. 30,000 as his capital. He also promises to bring in the necessary amount for his share of goodwill. On the date of admission the goodwill has been valued at Rs. 24,000 and the goodwill account already appears in the books at Rs. 12,000. C brings in for his share of goodwill and agrees that the existing goodwill account be written off. Pass the necessary journal entries.

(i) when writing off the existing goodwill does not affect the new partner's capital account.

(ii) when writing off the existing goodwill affects the new partners capital account.

Solution:

(i) When new partners capital account is not affected

The goodwill of the firm has been valued at Rs. 24,000. Goodwill already appearing in the books is Rs. 12,000 which is to be written off. When it is intended that writing off the existing goodwill should not affect the new partner's capital account the new partner shall bring in his share of full value of goodwill i.e. Rs. 8,000 $\left(\frac{1}{3} \text{ of } 24{,}000\right)$. This will be shared by the old partners in their ratio of sacrifice and then the existing goodwill of Rs. 12,000 shall be written off by debiting the old partners in their old ratio.

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			Rs.	Rs.
	Cash account	Dr.	38,000	
	C's capital account			38,000
	(Being the amount brought in by C as his capital Rs. 30,000 and Rs. 8,000 as his share of Goodwill)			
	C's capital account	Dr.	8,000	
	A's capital account			4,800
	B's capital account			3,200
	(By the goodwill brought in by C shared by the old partners in their ratio of sacrifice)			
	A's capital account	Dr.	7,200	
	B's capital account	Dr.	4,800	
	Goodwill account			12,000
	(Being the Goodwill already appearing in the books written off in the old ratio)			

(ii) When new partners capital account is affected

			Rs.	Rs.
	Cash account	Dr.	34,000	
	C's capital account			34,000
	(Being the amount of capital brought in by C Rs. 30,000 and Goodwill Rs. 4,000)			
	C's capital account	Dr.	4,000	
	A's capital account			2,400
	B's capital account			1,600
	(Being the Goodwill brought by C shared by A and B in their sacrifice ratio of 3 : 2)			
	A's capital account	Dr.	4,800	
	B's capital account	Dr.	3,200	
	C's capital account	Dr.	4,000	
	Goodwill account			12,000
	(Being Goodwill appearing in the books written off in the new profit sharing ratio of 6 : 4 : 5)			

WORKING NOTES:

1. **NEW PROFIT SHARING RATIO**

C's share of profit $= \frac{1}{3}$

Share of profit remaining for A and B $= 1 - \frac{1}{3} = \frac{2}{3}$

A's new share $= \frac{3}{5}$ of $\frac{2}{3} = \frac{6}{15}$

B's new share $= \frac{2}{5}$ of $\frac{2}{3} = \frac{4}{15}$

C's share $= \frac{1}{3}$ or $\frac{5}{15}$

Thus the new profit sharing ratio between A : B : C is 6 : 4 : 5.

2. **WHEN WRITING OFF THE EXISTING GOODWILL AFFECTS THE NEW PARTNER'S CAPITAL ACCOUNTS**

It means that Goodwill shall be debited to all the partners (including C) in their new profit sharing ratio. In that case C is required to bring in Rs. 4,000 (1/3 of additional goodwill of Rs. 12,000) only because the remaining Rs. 4,000 shall be debited to his capital account while writing off the existing goodwill.

ILLUSTRATION NO. 21

P and Q share profits in the ratio 3 : 2, R is admitted as a partner with 1/6 share. P and Q will in future get 2/3 and 3/6 share of profits. R pays Rs. 30,000 as goodwill. Partners decided to maintain goodwill account at Rs. 60,000. Record the concerned entries in the journal of the firm.

Solution:

			Rs.	Rs.
	Bank account	Dr.	30,000	
	Goodwill account			30,000
	(Being the amount brought in by R gas goodwill on admission as a partner with 1/6 share)			
	Goodwill account	Dr.	30,000	
	Q's capital account	Dr.	18,000	
	P capital account			48,000
	(Being goodwill brought by R paid to P along with $\frac{3}{30}$ of the good will to be contributed by Q because of a gain in the profit sharing ratio)			
	Goodwill account	Dr.	60,000	
	P's capital account			20,000
	Q's capital account			30,000
	R's capital account			10,000
	(Being goodwill raised as per agreement)			

Working Notes:

Sacrifice made by partners

$$P = \frac{3}{5} - \frac{2}{6} = \frac{18-10}{30} = \frac{8}{30} \quad Q = \frac{3}{6} - \frac{2}{5} = \frac{15-12}{30} = \frac{3}{30} \text{ (gain)}$$

Q has to pay $\frac{3}{30}$ for goodwill i.e. Rs. 18,000

P should get $\frac{8}{30}$ for goodwill i.e. Rs. 48,000

REVALUATION OF ASSETS AND LIABILITIES

When a new partner is admitted into the partnership concern, he acquires the ownership rights of the assets and also makes himself responsible for the liabilities of the firm. It is, therefore, desirable both from the point of view of the incoming partner as well as the existing partners that the assets and the liabilities as appearing in the Balance Sheet on the date of admission of the new partner should be properly valued. It is possible that some of the assets might have appreciated in value or proper depreciation has not been provided in the case of others, and no record has been made of such changes in the books of accounts. Therefore, on the admission of a partner, it is necessary to make a revaluation of all the assets and liabilities so that the true position of the partners at the date of such admission may be ascertained. Partners may agree as to whether the revised values of assets and liabilities should be shown in the books of the firm or not.

(a) When the revised values are to be recorded in the books

For the purpose of giving effect to the revaluation of assets and liabilities, a revaluation account or profit or loss adjustment account is opened in the books and the following entries are passed.

(i) For an increase in the value of assets

Debit respective asset account

Credit revaluation account

(ii) For a decrease in the value of assets

Debit revaluation account

Credit respective asset account

NOTE:- However, the decrease in the value of such assets as debtors, investments etc. is treated by creating an appropriate provision, that is, the book values remain constant and are not passed through the assets account. The amount of the provision, required either new or to the extent of an increase if any is debited to revaluation account and credited to provision account e.g. provision for doubtful debts or investment provision.

(iii) For an increase in the value of liabilities

Debit revaluation account

Credit respective liabilities account

(iv) For a decrease in the value of liabilities

Debit respective liabilities account

Credit revaluation account

(v) The balance of revaluation account is treated precisely like a profit and loss account balance viz.:

(a) If there is the excess of debits over credits i.e. if there is a loss, the revaluation account is credited and the capital accounts of the old partners are debited in their old profit sharing ratio.

(b) If there is excess of credits over debits, i.e. there is a profit, the revaluation account is debited and the capital accounts of the partners are credited in their old profit sharing ratio.

ILLUSTRATION NO. 22

The following was the Balance Sheet of A and B who were sharing profits 2/3 and 1/3 on 31st March, 1994.

Assets	*Rs.*	*Liabilities*	*Rs.*
Buildings	**25,000**	**Capital accounts**	
Plant and Machinery	**17,500**	**A**	**15,000**
Stock	**10,000**	**B**	**10,000**
Sundry debtors	**4,850**	**Sundry creditors**	**32,950**
Cash in hand	**600**		
	57,950		**57,950**

They agreed to admit C into partnership on the following terms:

(a) C was to bring Rs. 7,500 as his capital and Rs. 3,000 as goodwill for one–fourth share in the firm.

(b) That the values of the stock and plant and machinery were to be reduced by 5 %.

(c) That a reverse was to be created in respect of sundry debtors Rs. 375.

(d) That the buildings account was to be appreciated by 10 %.

(e) That goodwill money was to be retained in the business.

Pass the necessary journal entries to give effect to the above arrangements, prepare Revaluation account, the capital accounts and the new balance sheet.

Solution:

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			Rs.	Rs.
	Revaluation account Dr.		1,750	
	Stock account			500
	Plant and Machinery account			875
	Provision for doubtful debts			375
	(Being the stock and plant and machinery depreciated by 5 % and provision for doubtful debts created to the extent of Rs. 375)			

	Buildings account	Dr.	2,500	
	Revaluation account			2,500
	(Being the appreciation in the value of buildings)			
	Revaluation account	Dr.	750	
	A's capital account			500
	B's capital account			250
	(Being the profit on revaluation transferred to capital accounts)			
	Bank account	Dr.	10,500	
	C's capital account			7,500
	Goodwill account			3,000
	(Being the amount of capital and goodwill brought in by C)			
	Goodwill account	Dr.	3,000	
	A's capital account			2,000
	B's capital account			1,000
	(Being the goodwill transferred to capital accounts)			

REVALUATION ACCOUNT

		Rs.		Rs.
Stock		500	Buildings account	2,500
Plant and machinery account		875		
Provision for bad debts		375		
Profit on revaluation transferred to capital accounts:				
A 2/3	500			
B 1/3	250	750		
		2,500		2,500

A'S CAPITAL ACCOUNT

	Rs.		Rs.
Balance c/d	*17,500*	Balance b/d	15,000
		Revaluation A/c	500
		Goodwill account	2,000
	17,500		17,500

B'S CAPITAL ACCOUNT

	Rs.		Rs.
Balance c/d	*11,250*	Balance b/d	10,000
		Revaluation A/c	250
		Goodwill account	1,000
	12,250		12,250

C'S CAPITAL ACCOUNT

	Rs.		Rs.
Balance c/d	*7,500*	Bank A/c	7,500

BALANCE SHEET
as on 31st March, 1994

Assets		Rs.	*Liabilities*		Rs.
Buildings		27,500	Capital accounts:		
Plant and machinery		16,625	A	17,500	
Stock		9,500	B	11,250	
Sundry debtors	4,850		C	7,500	36,250
Less: Provision for			Sundry creditors		32,950
doubtful debts	375	4,475			
Cash in hand		11,100			
		69,200			69,200

(b) When the revised values are not to be recorded in the books

When a new partner is admitted into the partnership, the assets and liabilities may be revalued to put the old partners in their true positions. But all the partners may mutually agree to keep the old values of assets and liabilities unaltered in the books of the new firm. To record these a memorandum revaluation account is opened and increase in the value of assets and/or decrease in the value of liabilities are to be credited to this account while any decrease in the value of assets and/or increase in the value of liabilities are debited to such account, no record of such alterations is passed through the respective ledger accounts. The resultant profit or loss on revaluation is closed by transfer to the capital accounts of the old partners in their old profit sharing ratio. In order to complete the double entry, entries made in the memorandum revaluation account are reversed and the balance is transferred to the capital accounts of all the partners including new partner in their new profits sharing ratio.

REVALUATION ACCOUNT AND MEMORANDUM REVALUATION ACCOUNT

Revaluation account is prepared at the time of admission, retirement or death of a partner. In the case of revaluation account the assets and liabilities are shown in the new balance sheet at the revalued figures but in the case of memorandum revaluation, assets and liabilities are shown at their original book values. Memorandum revaluation account is prepared only in those cases where partners agree to keep the book values of assets and liabilities unchanged or unaltered.

ILLUSTRATION NO. 23

A and B are carrying on business in partnership as chemists sharing profits and losses in the ratio of 2 : 3 respectively. Their balance sheet on 31st December, 1993 was as under:

Assets	*Rs.*	*Liabilities*	*Rs.*
Cash in hand	1,420	Sundry creditors	24,870
Cash at book	23,850	Capital accounts	
Sundry debtors	11,000	A	68,100
Stock	36,000	B	68,100
Furniture	8,800		
Building	80,000		
	1,61,070		1,61,070

On that date they admitted C into partnership and give him one–third share in future profits on the following terms:

(a) Stock and furniture are to be reduced in value by $12\frac{1}{2}$ %.

(b) Buildings are to be appreciated by Rs. 15,000.

(c) A provision of 5 % is to be created on sundry debtors for doubtful debts.

(d) **C is to bring in Rs. 60,000 as his capital and Rs. 40,000 as goodwill, which sum is to remain in the business.**

(e) **The values of assets and liabilities other than cash are not to be altered.**

Draft journal entries to record the above arrangement and show the opening Balance Sheet of the new firm.

Solution:

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				Rs.	Rs.
	Bank account	Dr.		1,00,000	
	C's capital account				60,000
	Goodwill account				40,000
	(Being the amount brought in by C as his capital and goodwill)				
	Goodwill account	Dr.		40,000	
	A's capital account				16,000
	B's capital account				24,000
	(Being the goodwill transferred to old partners capital accounts)				
	Memorandum revaluation account	Dr.		8,850	
	A's capital account				3,540
	B's capital account				5,310
	(Being the profit on revaluation transferred to old partners in old profit sharing ratio)				
	A's capital account	Dr.		2,360	
	B's capital account	Dr.		3,540	
	C's capital account	Dr.		2,950	
	Memorandum revaluation account				8,850
	(Being the memorandum revaluation account closed by transfer to the capital accounts of all the partners in the new profit sharing ratio)				

Dr. **MEMORANDUM REVALAUTION ACCOUNT** Cr.

		Rs.		Rs.
Stock account		4,500	Buildings account	15,000
Furniture account		1,100		
Provision for doubtful debts		550		
Profit transferred to capital accounts:				
A	3,540			
B	5,310	8,850		
		15,000		15,000

	Rs.			Rs.
Building account	15,000	Stock account		4,500
		Furniture account		1,100
		Provision for doubtful debts		550
		Loss transferred to capital accounts:		
		A	3,260	
		B	3,540	
		C	2,950	8,850
	15,000			15,000

BALANCE SHEET OF ABC

as on 31st December, 1993

Assets	Rs.	*Liabilities*		Rs.
Cash in hand	1,420	Sundry creditors		24,870
Cash at bank	1,23,850	Capital accounts		
Sundry debtors	11,000	A	85,280	
Stock	36,000	B	93,870	
Furniture	8,800	C	57,050	2,36,200
Building	80,000			
	2,61,070			2,61,070

TREATMENT OF RESERVES

If, on admission, there is any such item like reserves or profit and loss account representing the undistributed profit of the previous years, appearing on the liability side of the Balance Sheet, the same would be closed by transfer to the capital accounts of the old partners in the old profit sharing ratio. This is to be done even if the question is silent on this point. The necessary journal entry would be:

Debit Reserve or profit and loss account

Credit Old partners capital accounts

ILLUSTRATION NO. 24

Tufail and Waris are partners sharing profits and losses in the ratio of 3:1. They agreed to admit Naeem into the partnership firm. Naeem to bring Rs. 40,000 as his capital and Rs. 12,000 as goodwill for 1/4th share of the future profits which he acquires in the ratio of 2:1 from Tufail and Waris. The amount of goodwill brought by Naeem is to remain in the business. At the time of Naeem's admission there is a general reserve for Rs. 16,000 appearing in the Balance Sheet of Tufail and Waris. The assets and liabilities were revalued as under:

(i) Building was appreciated by Rs. 20,000.

(ii) Provision for doubtful debts was reduced from Rs. 2,000 to Rs. 1,000.

(iii) A provision Rs. 1,000 was to be made for an outstanding bill for repairs.

Pass the necessary journal entries in connection with Naeem's admission.

Solution:

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				Rs.	Rs.
	Cash account	Dr.		52,000	
	Naeem's capital account				40,000
	Goodwill account				12,000
	(Being the amount brought in by Naeem as his capital Rs. 40,000 and goodwill Rs. 12,000)				
	Goodwill account	Dr.		12,000	
	Tufail's capital account				8,000
	Waris's capital account				4,000
	(Being the amount of goodwill transferred to Tufail and Waris's capital in the sacrifice ratio 2:1)				
	General reserve account Dr.			16,000	
	Tufail's capital account				12,000
	Waris's capital account				4,000
	(Being the amount of general reserve transferred to capital accounts of Tufail and Waris in the old profit sharing ratio)				

	Building account	Dr.	20,000	
	Provision for doubtful debts	Dr.	1,000	
	Revaluation account			21,000
	(Being the appreciation in the value of building by Rs. 20,000 and reduction in the provision for doubtful debts by Rs. 1,000)			
	Revaluation account	Dr.	1,000	
	Provision for repairs account			1,000
	(Being liability for repairs brought into account)			
	Revaluation account	Dr.	20,000	
	Tufail's capital account			15,000
	Waris's capital account			5,000
	(Being the profit on revaluation transferred to capital accounts)			

ADJUSTMENT REGARDING CAPITALS

It is sometimes agreed that on the admission of a new partner the capitals of all the partners should be in proportion to the new profit sharing ratio. The capital of the partners may be adjusted on the basis of the capital of the new partner or the new partner may himself be required to bring in the amount which should be equal to his share in the firm.

If the capital of the new partner is given the total capital of the firm can be found out on the basis of the capital of the incoming partner. Then the capital required by the other partners can be found out. **If the capital of old partners is in excess of the amount ascertained, the excess over the required amount may either be withdrawn or transferred to the credit of the current account. But if the capital of the old partner is less than the amount required then the old partner may be asked to bring in cash to make up the deficiency or the deficiency may be debited to the current account.**

ILLUSTRATION NO. 25

A and B are partners sharing profits and losses in the ratio of 3:2. C is admitted into the firm for 1/4 share of profits. C brings in Rs. 20,000 in respect of his capital. The capitals of old partners after all adjustments in respect of goodwill, revaluation of assets and liabilities etc. have been worked out at Rs. 40,000 for A and Rs. 20,000 for B. It is agreed that partners capitals will be according to new profits sharing ratio.

Determine the new capital of A and B and pass the necessary journal entries assuming that the partner whose capital falls short, brings in the amount of deficiency and the partner who has an excess withdraws the excess amount.

Solution:

New Profit Sharing Ratio

C's share $= \frac{1}{4}$

Balance profit $= 1 - \frac{1}{4} = \frac{3}{4}$

A's new share $= \frac{3}{4} \times \frac{3}{5} = \frac{9}{20}$

B's new share $= \frac{3}{4} \times \frac{2}{5} = \frac{6}{20}$

C's share $\frac{1}{4}$ or $\frac{5}{20}$

$\therefore$ The new profit sharing ratio between A, B and C is 9 : 6 : 5.

Required Capitals of A and B

C capital $\left(\text{whose has } \frac{1}{4} \text{ share in profit}\right)$ is Rs. 20,000. B's new share in profit $\frac{6}{20}$. Hence his share is Rs. 24,000. A's new share is $\frac{9}{20}$. Hence his capital will be Rs. 36,000.

Alternatively based on C's capital the total capital of the firm will work out at Rs. 80,000 $\left(\frac{4}{1} \times 20{,}000\right)$. Hence based on share in profits, the capitals of A and B will be

A's capital = $\frac{9}{20} \times 80{,}000 =$ Rs. 36,000

B's capital = $\frac{6}{20} \times 80{,}000 =$ Rs. 24,000

The capitals of A and B after all adjustments have been made are Rs. 40,000 and Rs. 20,000 respectively. Hence A will withdraw Rs. 4,000 (Rs. 40,000 – 36,000) from the firm whereas B will contribute additional amount of Rs. 4,000 (Rs. 24,000 – Rs. 20,000). The journal entries will be

			Rs.	Rs.
	A's capital account Dr.		4,000	
	Cash account			4,000
	(Being the excess amount withdrawn by A)			
	Cash account Dr.		4,000	
	B's capital account			4,000
	(Being the deficiency made good by additional amount brought in by B).			

ILLUSTRATION NO. 26

The following was the balance sheet of A, B and C sharing profits and losses in the proportion of 6/14, 5/14 and 3/14 respectively.

Assets	*Rs.*	*Liabilities*		*Rs.*
Land and buildings	50,400	Creditors		18,900
Furniture	7,350	Bills payable		6,300
Stock	29,400	Capital accounts:		
Debtors	26,460	A	39,900	
Cash	1,890	B	33,600	
		C	16,800	90,300
	1,15,500			1,15,500

They agreed to take D into partnership and give him one–eighth share on the following terms:

(a) That D should bring in Rs. 14,700 as his capital.

(b) That furniture be depreciated by Rs. 920.

(c) That stock be depreciated by 10 %.

(d) That a reserve of Rs. 1,320 be made for outstanding repairs bills.

(e) That the value of land and buildings having appreciated be brought upto Rs. 65,100.

(f) That a goodwill account be raised at Rs. 8,820 and be adjusted in old partners capital accounts.

(g) That after making the above adjustments the capital accounts of the old partners (who continue to share in the same proportion as above) be adjusted on the basis of the D's capital to his share in the business.

Pass journal entries to give effect to the above arrangements and prepare the opening balance sheet of the firm as newly constituted.

Solution:

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			Rs.	Rs.
	Revaluation account Dr.		5,180	
	Furniture account			920
	Stock account			2,940
	Provision for repairs			1,320
	(Being the fall in the value of various assets and the creation of liability in respect of repairs)			
	Land and buildings account Dr.		14,700	
	Revaluation account			14,700
	(Being the increase in the value of land and building)			
	Revaluation account Dr.		9,520	
	A's capital account			4,080
	B's capital account			3,400
	C's capital count			2,040
	(Being the profit on revaluation transferred to capital accounts)			
	Goodwill account Dr.		8,820	
	A's capital account			3,780
	B's capital account			3,150
	C's capital account			1,890
	(Being the value of goodwill credited to old partners in the old ratio of 6 : 5 : 3)			
	Cash account Dr.		14,700	
	D's capital account			14,700
	(Being cash brought in by D as his capital)			
	A's capital account Dr.		3,660	
	B's capital account Dr.		3,400	
	Cash account			7,060
	(Being the excess amount refunded to A and B on adjustment of capitals)			
	Cash account Dr.		1,320	
	C's capital account			1,320
	(Being the amount brought in by C on adjustment of capital)			

REVALUATION ACCOUNT

	Rs.		Rs.
Furniture account	920	Lnd and buildings	14,700
Stock account	2,940		
Provision for repairs	1,320		
Profit transferred to capitals			
A 4,080			
B 3,400			
C 2,040	9,520		
	14,700		14,700

A'S CAPITAL ACCOUNT

	Rs.		Rs.
Cash account	3,660	Balance b/d	39,900
Balance c/d	*44,100*	Revaluation account	4,080
		Goodwill account	3,780
	47,760		47,760

B'S CAPTIAL ACCOUNT

	Rs.		Rs.
Cash account	3,400	Balance b/d	33,600
Balance c/d	*36,750*	Revaluation account	3,400
		Goodwill account	3,150
	40,150		40,150

C'S CAPITAL ACCOUNT

	Rs.		Rs.
Balance c/d	*22,050*	Balance b/d	16,800
		Revaluation account	2,040
		Goodwill account	1,890
		Cash account	1,320
	22,050		22,050

GOODWILL ACCOUNT

	Rs.		Rs.
A's capital account	3,780	*Balance c/d*	*8,820*
B's capital account	3,150		
C's capital account	1,890		
	8,820		8,820

CASH ACCOUNT

	Rs.		Rs.
Balance b/d	1,890	A's capital account	3,660
D's capital account	14,700	B's capital account	3,400
C's capital account	1,320	Balance c/d	10,850
	17,910		17,910

ABCD
BALANCE SHEET

Assets	Rs.	*Liabilities*	Rs.
Cash	10,850	Creditors	18,900
Stock	26,460	Bills payable	6,300
Debtors	26,460	Provision for repairs	1,320
Furniture	6,430	Capital accounts	
Land & buildings	65,100	A	44,100
Goodwill	8,820	B	36,750
		C	22,050
		D	14,700
	1,44,120		1,44,120

ILLUSTRATION NO. 27

A and B partners in a business sharing profits and losses equally. Their original capitals were **s. 30,000 and 20,000 respectively. The admit a new partner C with 1/5 share of profit. The** **valuation of assets and liabilities shows a profit of Rs. 10,000. They had also Rs. 20,000 as general** **erve. C is required to bring proportionate capital. Show how much capital C should bring?**

Solution:

STEP 1: Calculation of the balance of A's and B's capital in the new firm

	A	B
Original capitals	30,000	20,000
Profit on revaluation	5,000	5,000
General reserve	10,000	10,000
	45,000	35,000

STEP 2: Calculate of the total capital of the new firm

Total share of A and B in the new firm $= 1 - \frac{1}{5} = \frac{4}{5}$

As $\frac{4}{5}$ capital of the new firm $=$ 80,000

$\therefore$ Total capital of the new firm $= 80{,}000 \times \frac{5}{4} = 100{,}000$

$\frac{1}{5}$ th capital of the firm $= 10{,}000 \times \frac{1}{5} = 20{,}000$

$\therefore$ C's capital $= 20{,}000$

PARTNERSHIP ACCOUNTS (II RETIREMENT AND DEATH

RETIREMENT OF A PARTNER

It has already been discussed in the previous chapter that partnership is the relation among partners based on mutual agreement. So partnership is formed, continues and is dissolved by the mutual consent of the partners. So any partner can retire by giving a notice to the other partners of his intention to retire. Retirement of any partner dissolves the partnership relation but firm may continue to exist if other partners so desire.

ACCOUNTING PROBLEMS ON RETIRMENET

1. Calculation of ratios–new profit sharing and gaining.
2. Treatment of goodwill.
3. Revaluation of assets and liabilities.
4. Treatment of accumulated profits and reserves.
5. Mode of payment to retiring partner.
6. Capital accounts–readjustments.

All the above mentioned problems are discussed below:

1. NEW PROFIT SHARING RATIO

On the retirement of a partner, the share of the retiring partner will be taken over by the remaining partners. It will, therefore, become necessary to calculate the new profit sharing ratio of remaining partners. The remaining partners may agree that after retirement they will share the future profits in the same proportion as before, or they may agree that after the retirement of the partner, they will share the profit either equally or in a certain agreed proportion. The following illustrations will make the concept clear:

CASE I:

When a partner retires and there is no fresh agreement among the continuing partners. It is presumed that they will share the future profits in the same relative proportion as before. This is done by striking out the share of the retiring partner and by finding out the new denominator of the remaining ratio.

Suppose, A, B and C are partners sharing profits in the ratio of $\frac{1}{2}$, $\frac{1}{3}$ and $\frac{1}{6}$. Find out the new ratio of the remaining partners (i) if A retires, (ii) B retires (iii) C retires.

Solution:

Profit sharing ratio of A, B and C is $\frac{1}{2} : \frac{1}{3} : \frac{1}{6}$ or $3 : 2 : 1$.

If A retires share between B and C $2 : 1$ i.e. $\frac{2}{3} : \frac{1}{3}$

If B retires share between A and C $3 : 1$ i.e. $\frac{3}{4} : \frac{1}{4}$

If C retires share between A and B $3 : 2$ i.e. $\frac{3}{5} : \frac{2}{5}$

CASE II:

Often happens that sometimes the continuing partners purchase the share of the retiring partner. In that case, the new ratio of the remaining partners is calculated by adding to their old ratio that which they have purchased.

Suppose, A, B and C are partners sharing profits in the ratio of $\frac{1}{2}$, $\frac{3}{10}$ and $\frac{2}{10}$ respectively. B retires and his share is taken up by A and C in the ratio of 2 : 1. Find out the new profit sharing ratio.

Solution:

A takes $\frac{2}{3}$ of $\frac{3}{10}$ i.e., $\frac{2}{10}$ from B

$\therefore$ A's new share $\frac{5}{10} + \frac{2}{10} = \frac{7}{10}$

C takes $\frac{1}{3}$ of $\frac{3}{10}$ i.e., $\frac{1}{10}$ from B

$\therefore$ C's new share $\frac{2}{10} + \frac{1}{10} = \frac{3}{10}$

Profit sharing ratio between A and C: $\frac{7}{10} : \frac{3}{10}$ or 7 : 3.

GAINING RATIO

Calculation of gaining ratio is necessary for the distribution of goodwill. In case where it is desired not to raise goodwill account but to adjust goodwill through the capital accounts of the partners, the capital account of the retiring partner is credited with his share of goodwill and capital account of remaining partners are debited in their gaining ratio.

It is the ratio in which remaining partners gain out of the retiring partner's share. Remaining partners may gain additional share (out of the retiring partner's share) in their previous ratio or in any other agreed ratio. ***Gaining ratio is calculated by deducting his old share from his new share.***

DISTINCTION BETWEEN GAINING AND SACRIFICING RATIO

1. Sacrificing ratio is calculated at the time of admission of a new partner while gaining ratio is calculated in the event of retirement or death of a partner.
2. Sacrificing ratio is the proportion in which old partners have sacrificed their profit sharing proportion whereas gaining ratio is the proportion in which continuing partners have gained the profit sharing proportion.
3. In sacrificing ratio we calculate the sacrifice made by existing partner in favor of incoming partner whereas in gaining ratio we calculate the gain of the continuing partner out of the proportion of outgoing (retiring or deceased) partner.
4. Sacrificing ratio calculates sacrifice as old share – new share.
   Gaining ratio calculates gains
   New share – old share.
5. Sacrificing ratio is used to compensate old partners on account of goodwill i.e. old partners capital accounts are credited whereas gaining ratio is used to charge continuing partners on account of goodwill i.e. continuing partners capital accounts are debited.

2. TREATMENT OF GOODWILL

A partner on his retirement is entitled to his share of goodwill of the firm. This share is determined either according to the original agreement or by valuation. Such an amount is credited to his capital account as to represent his proportion of the value of goodwill according to his share of profit.

Following are the various methods for the treatment of goodwill at the time of retirement.

EXAMPLE:

A, B and C are partners, sharing profits in the ratio of 5 : 3 : 2. C retires. Goodwill of the entire from is valued at Rs. 36,000. Pass necessary journal entries regarding goodwill in all cases.

CASE I:

GOODWILL IS RAISED AT FULL VALUE

Goodwill is raised in the books of the firm at full value debiting the goodwill account and crediting the capital accounts of all the partners in the old profit sharing ratio. In this case, goodwill account will appear in the books of the continuing partners at the full value. The necessary entry for raising the goodwill in the books of the firm is:

Goodwill	Dr.	(Full value)	
All Partner's Capital A/c			
Goodwill account	Dr.	36,000	
A's capital account			18,000
B's capital account			10,800
C's capital account			7,200

Goodwill in the present case has been raised at Rs. 36,000 on the assumption that the goodwill account already does not appear in the books of the firm. ***If the goodwill account already appears in the books then the entry is passed only for the difference between the full value and the value at which goodwill already appears in the books.*** The entry in such a case is to debit goodwill account with the difference and to credit the capital accounts of all partners including the retiring partner in the old profit sharing ratio. If for instance goodwill account appears in the books at Rs. 16,000 and the value of goodwill on the retirement of C is estimated at Rs. 36,000, then the entry for goodwill will be passed only with the difference i.e., with Rs. 20,000. The necessary entry would be

Goodwill account	Dr.	20,000	
A's capital account			10,000
B's capital account			6,000
C's capital account			4,000

Where goodwill account appears in the books at more than the full value, difference between the book value and the full value, is credited to the goodwill account and debited to the capital accounts of all the partners in the old profit sharing ratio. If we assume that at the time of B's retirement, goodwill already

appears in the books at Rs. 50,000, then the decrease in the value of goodwill i.e., Rs. 14,000 is duly accounted for crediting the goodwill account and debiting the capital accounts of all the partners including the retiring partner in the old profit sharing ratio. The necessary journal entry is:

A's capital account	Dr.	7,000	
B's capital account	Dr.	4,200	
C's capital account	Dr.	2,800	
Goodwill account			14,000

CASE II:

GOODWILL IS RAISED AT FULL VALUE AND WRITTEN OFF

In that case goodwill account will be written off by debiting the capital accounts of the remaining partners in their new profit sharing ratio. If A & B in the present case decide to write off the goodwill account, the necessary entry would be

A's capital account	Dr.	22,500	
B's capital account	Dr.	13,500	
Goodwill account			36,000

When the Goodwill account is written off, it will not be shown in the books of the new firm.

It is important to note that whenever goodwill account is raised at full value, goodwill account will be debited and partner's capital accounts are credited in the old ratio and when written off remaining partner's capital accounts are debited in the new ratio.

CASE III:

GOODWILL IS RAISED WITH RETIRING PARTNER'S SHARE ONLY

In this case retiring partner's share out of the total goodwill of the from is calculated and journal entry is passed _____

Goodwill account	Dr. x x x		{with the share of goodwill of retiring partner only.
Retiring partner's capital account		x x x	

In the above example, the entry will be;

Goodwill account	Dr. 7200	
C's Capital Account		7200

CASE IV:

GOODWILL RAISED, PARTIALLY AND WRITTEN OFF

In this case first entry is same as in Case III above. Entry for writing off the goodwill is passed debiting continuing partner's capital accounts in the ratio in which they gain on retirement.

A's capital account	Dr.	4,500	
B's capital account	Dr.	2,700	
Goodwill account			7,200

CASE V:

WHEN GOODWILL IS NOT RAISED

In case it is desired not to raise the goodwill account in the books, the share of goodwill of the outgoing partner may be credited to his capital account and debited to the capital accounts of the continuing partners in the ratio in which they gain on retirement.

A's capital account	Dr.	4,500	
B's capital account	Dr.	2,700	
C's capital account			7,200

ILLUSTRATION NO. 28

A, B and C are partners sharing profits and losses in the ratio of $\frac{1}{2} : \frac{1}{3}$ and $\frac{1}{6}$ respectively. A retires from the firm and B and C decide to share the future profits in the ratio of 5 : 3. Goodwill does not appear in the books but it is expected to be worth Rs. 24,000. Pass entries for goodwill in all the cases.

Solution:

			Rs.	Rs.
	Case (a) When goodwill is raised in the books at full value.			
	Goodwill account Dr.		24,000	
	A's capital account			12,000
	B's capital account			8,000
	C's capital account			4,000
	(Being the amount of goodwill raised on A's retirement)			
	Case (B) When goodwill is raised in the books at full value and is immediately written off			
	Goodwill account Dr.		24,000	
	A's capital account			12,000
	B's capital account			8,000
	C's capital account			4,000
	(Being the amount of goodwill raised on A's retirement)			
	B's capital account Dr.		15,000	
	C's capital account Dr.		9,000	
	Goodwill account			24,000
	(Being the amount of goodwill raised on A's retirement now written off)			

	Case (c) When goodwill is raised with the share of retiring partner			
	Goodwill account	Dr.	12,000	
	A's account			12,000
	(Being A's share of goodwill raised in the books)			
	B's capital account	Dr.	7,000	
	C's capital account	Dr.	5,000	
	Goodwill account			12,000
	(Being A's share of goodwill raised on his retirement written off to the capital accounts of the continuing partners in the ratio of their gain i.e., 7 : 5)			

In case it is desired not to raise a goodwill account in the books, the necessary entry would be.

			Rs.	*Rs.*
	B's capital account	Dr.	7,000	
	C's capital account	Dr.	5,000	
	A's capital account			12,000
	(Being A's share of goodwill debited to the capital accounts of the continuing partners in the ratio of their gain)			

REVALAUTION OF ASSETS AND LIABILITIES

Just like admission, the retirement of a partner necessitates revaluation of assets and liabilities. A profit and loss adjustment account or revaluation account is opened exactly in the same way as shown at the time of admission. The profit arising out of increase in the value of assets and decrease in the value of liabilities is credited to the revaluation account. The loss arising out of decrease in the value of assets and increase in the value of liabilities is debited to the revaluation account. The resulting profit or loss will be closed by transfer to the capital accounts of all the partners including the outgoing partner in the old profit sharing ratio.

TREATMENT OF UNRECORDED ASSETS AND LIABILITIES

It may happen that certain assets belonging to the firm may not appear in books but when sold fetch some amount. Such amount realized should be recorded as:-

	Bank account	Dr.		
	Revaluation account			
	(Being sale proceeds of unrecorded asset)			

Similarly if firm has to pay for some liabilities not appearing in the books the payment made should be recorded as:–

	Revaluation account Dr.			
	Bank account			
	(Being unrecorded liability discharged)			

EFFECT OF REVALAUTION ON NEW BALANCE SHEET

The values of assets and liabilities resulting from revaluation shall be incorporated in books. So, in new balance sheet the items will be shown at revalued figures. However, where continuing partners wish not to adopt revalued figures in their books then revaluation account should be prepared on memorandum basis as explained earlier.

TREATMENT OF RESERVES AND UNDISTRIBUTED PROFITS

The reserves and the undistributed profits appearing in the balance sheet on the date of retirement or death of a partner will be transferred to the capital accounts of the partners by debiting the reserves/profit and loss account and crediting the capital accounts of all the partners in their old profit sharing ratio. Alternatively the share of the outgoing partner may be transferred to his capital account, the share of the continuing partners may be shown on the liability side of the balance sheet.

ILLUSTRATION NO. 29

L, M and N are partners in a firm sharing profits and losses in the ratio 3 : 1 : 1. Balance sheet of the firm as on December 31, 1992 was as under:-

Assets	*Rs.*	*Liabilities*		*Rs.*
Sundry assets	**34,000**	**Capitals:**		
Profit & loss account	**2,000**	**L**	**15,000**	
		M	**9,000**	
		N	**6,000**	**30,000**
		General reserve		**6,000**
	36,000			**36,000**

N retires on 1st January, 1993. Pass the necessary journal entries regarding reserves/losses if any.

Solution:

			Rs.	Rs.
1993				
Jan. 1	Reserve Fund account Dr.		6,000	
	L's capital account			3,600
	M's capital account			1,200
	N's capital account			1,200
	(Being reserve fund transferred to partners capital accounts in profit sharing ratio).			
Jan. 1	L's capital account Dr.		1,200	
	M's capital account Dr.		400	
	N's capital account Dr.		400	
	Profit and loss account			2,000
	(Being loss in the business debited to partners in their profit sharing ratio)			

DETERMINATION OF AMOUNT DUE TO RETIRING PARTNER

Amount becoming due to the retiring partner is determined by preparing his capital account on the date of retirement.

Retiring partner's capital account shall have following items on credit side –

(i) Opening balance as on the date of previous balance sheet.

(ii) Goodwill – his proportion of the total goodwill.

(iii) Profit and reserves – his proportion of the reserves and accumulated profits appearing in the previous balance sheet.

(iv) Interest on capital from the date of the previous balance sheet to the date of retirement at agreed rate.

(iv) Interest on capital from the date of the previous balance sheet to the date of retirement at agreed rate.

(v) Profit on revaluation's share.

(vi) Joint life policy's surrender value – his share.

(vii) Share of profit from the closing of previous accounts to the date of retirement – it may be ascertained as per agreement among partners. Usually it is based on previous year's profit or on sales basis.

Example:

(Previous year's profit as a base). A, B and C are equal partners. Profit of the firm for the year ending December 31, 1992 was Rs. 24,000. A retires on June 30, 1993. A's share of profit.

Profits for full year = 24,000

Profits for half year = 24,000 ÷ 2 = 12,000

A's share = 12,000 ÷ 3 = Rs. 4,000.

Example:

(On sale basis) A, B and C are equal partners in a firm. Firm's rate of gross profit to sales is 30 percent. Firm's accounting year ends on December 31 every year. A retires on March 31, 1993. Sales during January 1 to March 31 amounted to Rs. 30,000.

A's share of profit:	Rs.
Sales of the firm	30,000
Profit of the firm (30 % of 30,000)	9,000
A's share (one–third)	Rs. 3,000

Retiring partner's capital account is likely to have the following items on debit side –

(i) Balance (if capital account is having debit balance)

(ii) Share of accumulated losses if any)

(iii) Drawings

(iv) Interest on drawings

(v) Share of loss on revaluation if any.

RETIRING PARTNER'S CAPITAL ACCOUNT

(Specimen)

Drawings	Balance b/d
Interest on drawings	Goodwill a/c
Revaluation a/c (loss)	Profit & loss a/c
Profit & loss a/c (loss)	Reserves
Bank (immediate payment)	Interest on capital
Retiring partner's loan a/c	Revaluation a/c (profit)
(balancing figure)	Joint life policy (share)

REPAYMENT OF THE AMOUNT DUE TO THE RETIRING PARTNERS

Amount due to the outgoing partner is found out by preparing his capital account as explained earlier.

The amount due to the retiring partner is paid off according to the agreement between the partners. However, in the absence of any agreement, outgoing partner has the option either to claim interest on the amount of his share in the property of the firm at a rate of 6 per cent annum or to such a share of the subsequent profits as may be attributable to the use of his share of the property of the firm.

Repayment be made in any of the following methods:-

1. Payment in full at the time of retirement:

In this case funds for repayment may be provided out of

(a) firm's own resources

(b) borrowings by the firm

(c) additional funds may be brought in by continuing partners.

At the time of repayment retiring partner's capital account is debited and cash/bank account is credited.

2. Purchase by continuing partners:

In this case amount due to retiring partner is debited to his capital account and continuing partner's capital accounts are credited as per agreement between them. Continuing partners will satisfy the claim of the retiring partner individually in their private capacity. Firm is out of the picture.

3. Converting retiring partner's capital into loan and repayment as per following method:-

It may not be practicable for firm to discharge the debt due to a retired partner out of the existing resources, nor may it be possible immediately for the other partners to bring in additional capital. In such circumstances one of the following methods of settlement may be adopted:

(a) Repayment may be made by agreed installments over a period of year, interest being allowed on the diminishing balance on the amount due.

(b) The amount due may be regarded as loan to the firm to carry the right to either a fixed rate of interest or a share of the profits of the firm.

(c) An annuity may be paid to a retired partner for life or for an agreed number of years or for the life of some dependant.

(a) Repayment of outgoing partners capital i.e. by installments

The amount due to retired partner is either paid out to him forthwith or by installments. The loan account is credited with interest due from time to time and will be debited with installments paid unless the whole amount is paid off.

NOTE:

Only first method of payment has been illustrated.

ILLUSTRATION NO. 30

The balance sheet of O, P and Q who are sharing profit and losses in the proportion of one–half, one–third and one–sixth respectively was as follows on the 30th June, 1990:

Assets	*Rs.*	*Liabilities*		*Rs.*
Cash in hand	150	Bills payable		6,400
Cash at bank	25,500	Sundry creditors		12,500
Bills receivable	5,400	Capital:		
Book debts	17,800	O	40,000	
Stock	22,300	P	25,000	
Furniture	3,500	Q	20,000	85,000
Plant & Machinery	9,750	Profit & loss account		4,500
Buildings	24,000			
	1,08,400			1,08,400

O retires from the business from 1st July, 1990 and his share in the firm is to be ascertained on a revaluation of the assets as follows:

Stock 20,000; furniture 3,000; plant & machinery 9,000; building 20,000. Rs. 850 are to be provided for doubtful debts. The goodwill of the firm is agreed to be valued at Rs. 6,000.

O is to be paid Rs. 11050 in cash on retirement and the balance in three equal yearly installments with interest at 5 % p.a.

Pass the journal entries, show the necessary accounts required to give effect to the above, balance sheet of the continuing partners.

Solution:

JOURNAL

1993			Rs.	Rs.
	Profit and loss account	Dr.	4,500	
	O's capital account			2,250
	P's capital account			1,500
	Q's capital account			750
	(Being the profit transferred to capital accounts in the profit sharing ratio)			

Revaluation Dr.		8,400	
Stock			2,300
Furniture			500
Plant & Machinery			750
Buildings			4,000
Provision for doubtful debts			850
(Being the decrease in the value of various assets)			
O's capital account Dr.		4,200	
P's capital account Dr.		2,800	
Q's capital account Dr.		1,400	
Revaluation			8,400
(Being the loss on the revaluation transferred to the capital accounts in the old profit sharing ratio)			
Goodwill account Dr.		6,000	
O's capital account			3,000
P's capital account			2,000
Q's capital account			1,000
(Being the goodwill raised in the book)			
P's capital account Dr.		4,000	
Q's capital account Dr.		2,000	
Goodwill account			6,000
(Being the goodwill written off to the remaining partners in new ratio)			
O's capital account Dr.		41,050	
O's loan account			41,050
(Being the amount due to M transferred to his loan account on his retirement)			

Dr. **REVALUATION ACCOUNT** **Cr.**

	Rs.			Rs.
Stock	2,300	Loss transferred to capital		
Furniture	500	accounts:		
Plant & Machinery	750	O1/2	4,200	
Buildings	4,000	P1/3	2,800	
Provision for doubtful debts	850	Q1/6	1,400	8,400
	8;400			8,400

GOODWILL ACCOUNT

	Rs.		Rs.
O's capital account	3,000	O's capital account	4,000
P's capital account	2,000	P's capital account	2,000
Q's capital account	1,000		
	6,000		6,000

O'S CAPITAL ACCOUNT

	Rs.		Rs.
Revaluation account (loss)	4,200	Balance b/d	40,000
O's loan account	41,050	Goodwill	3,000
		Profit and loss account	2,250
	45,250		45,250

P'S CAPITAL ACCOUNT

	Rs.		Rs.
Revaluation account (loss)	2,800	Balance b/d	25,000
Goodwill account	4,000	Goodwill account	2,000
Balance b/d	21,700	Profit & loss account	1,500
	28,500		28,500

Q'S CAPITAL ACCOUNT

	Rs.		Rs.
Revaluation account (loss)	1,400	Balance b/d	20,000
Goodwill account	2,000	Goodwill account	1,000
Balance c/d	18,350	Profit and loss account	750
	21,750		21,750

BALANCE SHEET OF P & Q
on 1st July 1990

Assets		Rs.	Liabilities		Rs.
Cash in hand		150	Bills payable		6,400
Cash at bank		25,500	Sundry creditors		12,500
Bills receivable		5,400	O's loan account		41,050
Book dents	17,800		Capital accounts:		
Less: Provision	850	16,950	P	21,700	
Stock		20,000	Q	18,350	40,050
Furniture		3,000			
Plant & Machinery		9,000			
Buildings		20,000			
		100,000			100,000

ADJUSTMENT OF CAPITAL

In same cases continuing partners may agree to fix the capital of the firm to a specified amount or to lay down that the capital shall be in their profit sharing ratio. If so, the specified capital is allocated among continuing partners in their new profit sharing ratio. Allocated amount of capital of each partner is compared with his existing capital. Any surplus over the allocated amount is either allowed to be withdrawn by the concerned partner or is credited to partner's current account. Similarly any deficiency is made up either by the concerned partner bringing further cash or debiting his current account.

ILLUSTRATION NO. 31

A, B and C are partners sharing profits & losses in the ratio of 4 : 3 : 2. B retires. A and C fix the entire capital of the new firm at Rs. 27,000 in the profit sharing ratio. The capital accounts of A and C show balance of Rs. 20,150 and Rs. 7,650 respectively immediately after B's retirement. Show the adjustment of capital accounts if (a) Partners are to bring in cash deficiency or to withdraw the surplus. (b) Partners capitals are adjusted through current accounts.

Solution:

Capital (as fixed) of the new firm Rs. 27,000

New profit sharing ratio of A and C = 4 : 2 or 2 : 1

A's adjusted capital = $27,000 \div 3 \times 2$ = 18,000

C's adjusted capital = $27,000 \div 3 \times 1$ = 9,000

(a)

CAPITAL ACCOUNTS

Dr. **Cr.**

	A Rs.	C Rs.		A Rs.	C Rs.
Cash account	2,150	—	Balance b/d	20,150	7,650
Balance c/d	18,000	9,000	Cash account	—	1,350
	20,150	9,000		20,150	9,000

Working Notes:

			Rs.
1.	A's capital account – opening balance	(+)	20,150
	Required capital of A	(–)	18,000
	Surplus refunded	=	2,150
2.	C's capital account – Opening balance	(–1)	7,650
	Required capital of C	(+)	9,000
	Deficiency to be brought in cash	=	1,350

JOURNAL ENTRIES

			Rs.	Rs.
	A's capital account Dr.		2,150	
	Cash account			2,150
	(Being surplus withdrawn by A)			
	Cash account Dr.		1,350	
	C's capital account			1,350
	(Being deficiency made up by cash)			

(b)

CAPITAL ACCOUNTS

Dr. Cr.

	A Rs.	C Rs.		A Rs.	C Rs.
Current account	2,150	—	Balance b/d	20,150	7,650
Balance c/d	18,000	9,000	Current account	—	1,350
	20,150	9,000		20,150	9,000

CURRENT ACCOUNTS

Dr. Cr.

	A Rs.	C Rs.		A Rs.	C Rs.
C's capital account	—	1,350	A's capital account	2,150	—
Balance c/d	2,150	—	Balance c/d	—	1,350
	2,150	1,350		2,150	1,350

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			Rs.	Rs.
	A's capital account Dr.		2,150	
	A's current account			2,150
	(Being surplus capital credited to current account)			
	C's current account Dr.		1,350	
	C's capital account			1,350
	(Being deficiency of C's capital debited to his current a/c)			

In few cases the firm may not specify the total capital but agree to adjust the balances of partners capital accounts in their profit sharing ratio. In such a case the balances of continuing partners' capital accounts (after the retirement) shall be added and the total will be allocated between continuing partners in their new profit sharing ratio. Adjustment of surplus/deficiency on capital account may be adjusted either in cash or through current accounts as per agreement.

Continuing above example:-

	Rs.
Balance in A's capital account	20,150
Balance in C's capital account	7,650
Total capital of the firm	27,800

New profit sharing ratio of A and C = 2 : 1

Required capital of A = $27{,}800 \times 2 \div 3$ = 18,533.33

say Rs. 18,533 (rounded of to the nearest rupee)

Required capital of C = $27{,}800 \times 1 \div 3$ = 9,266.67 say Rs. 9,267

(rounded off to the nearest rupee)

JOURNAL ENTRIES

(when adjustment is through cash)

				Rs.	Rs.
	A's capital account	Dr.		1,617	
	Cash account				1,617
	(Being surplus withdrawn by A)				
	Cash account	Dr.		1,617	
	C's capital account				1,617
	(Being deficiency made up by C bringing cash)				

JOURNAL ENTRIES

(when adjustment is through current accounts)

				Rs.	Rs.
	A's capital account	Dr.		1,617	
	A's current account				1,617
	(Being surplus credited to current account)				
	B's capital account	Dr.		1,617	
	B's capital account				1,617
	(Being deficiency to current account)				

ILLUSTRATION NO. 32

X, Y and Z are partners sharing profits in the ratio of their capitals. Y retired from the firm on 31.12.1991, the date on which the Balance Sheet of the firm was as follows:-

Assets		*Rs.*	*Liabilities*		*Rs.*
Cash		5,400	Sundry creditors		4,000
Debtors	6,000		Bills payable		2,500
Less: Provision	400	5,600	Outstanding salary		500
Stock		10,000	Capitals:		
Machinery		28,000	X	30,000	
Land & buildings		30,000	Y	24,000	
			Z	18,000	72,000
		79,000			79,000

The following adjustments were made:-

(i) Building appreciated by 20 %.

Stock depreciated by 10 %.

Provision for doubtful debts was to be 5 %.

A reserve for legal charges payable was to be made at Rs. 900.

(ii) Goodwill of the firm be valued at Rs. 12,000 and Y's share in it be adjusted into the capital accounts of X and Z without opening goodwill account.

(iii) Rs. 24,000 from Y's capital account be transferred to his loan account and the balance be paid in cash.

(iv) New profits sharing ratio of X and Z to be 3 : 2. Give the necessary ledger accounts and the Balance Sheet of the firm after Y's retirement.

Solution:

REVALUATION ACCOUNT

Dr. Date	References		Amount Rs.	Date	References	Cr. Amount Rs.
1991				1991		
Dec. 31	Stock		1,000	Dec. 31	Land and buildings account	6,000
Dec. 31	Reserve for legal charges		900			
Dec. 31	Profit transferred to capital accounts:			Dec. 31	Provision for doubtful debts	100
	X (5/12)	1,750				
	Y (4/12)	1,400				
	Z (3/12)	1,050	4,200			
			6,100			6,100

X'S CAPITAL ACCOUNT

Dr.		Rs.			Cr. Rs.
1991			1991		
Dec. 31	Y's capital account	2,200	Dec. 31	Balance b/d	30,000
Dec. 31	Balance c/d	29,550	Dec. 31	Revaluation account (Profit)	1,750
		31,750			31,750
			1992		
			Jan. 1	Balance b/d	29,550

Y'S CAPITAL ACCOUNT

Dr.		Rs.			Cr. Rs.
1991			1991		
Dec. 31	Cash account	5,400	Dec. 31	Balance b/d	24,000
Dec. 31	Y's loan account	24,000	Dec. 31	Revaluation account (Profit)	1,400
			Dec. 31	X's capital account (goodwill)	2,200
				Y's capital account (goodwill)	1,800
		29,400			29,400

Dr. **Z'S CAPITAL ACCOUNT** Cr.

		Rs.			Rs.
1991			1991		
Dec. 31	Y's capital account (goodwill)	1,800	Dec. 31	Balance b/d	18,000
Dec. 31	Balance c/d	17,250	Dec. 31	Revaluation account (Profit)	1,050
		19,050			19,050
			1992		
			Jan. 1	Balance b/d	17,250

BALANCE SHEET
OF M/S X & Z
as on 1.1.1992

Assets		*Rs.*	*Liabilities*		*Rs.*
Debtors	6,000		Sundry creditors		4,000
Less: Provision	300	5,700	Bills payable		2,500
Stock		9,000	Outstanding salary		500
Machinery		28,000	Reserve for legal charges		900
Land and buildings		36,000	Y's Loan		24,000
			Capitals:		
			X	29,550	
			Y	17,250	46,800
		78,700			78,700

WORKING NOTES:

$$\text{Y's share goodwill} = 12{,}000 \times \frac{4}{12}$$

$$= 4{,}000$$

This is to be debited to the capital accounts of X and Z in their gaining ratio which is calculated as follows:-

X's Gain = New share – Old share

$$= \frac{3}{5} - \frac{5}{12} = \frac{36-25}{60} = \frac{11}{60}$$

Z's Gain $$= \frac{2}{5} - \frac{3}{12} = \frac{24-15}{60} = \frac{9}{60}$$

Gaining ratio = X : Z = 11 : 9.

DEATH OF A PARTNER

Death is certain so any partner may die at any time. Death of the partner dissolves the partnership but the firm may continue. However, death of any partner generates lot of difficulties for the continuance of the firm. Therefore, partnership deed generally contains provisions regarding settlement of the account of the deceased partner.

Whatever is due to the deceased partner (as per partnership deed) should be credited to his capital account. Usual items are:-

(a) Balance of deceased partner's capital account
(b) Balance of deceased partner's current account
(c) Share of profit from the last balance sheet to the date of death
(d) Share of profit on revaluation of assets and liabilities
(e) Share of undistributed profits/reserves/accumulated earnings
(f) Share of goodwill
(g) Share of joint life policy
(h) Any salary due to him
(i) Interest on capital
(j) Any other amount payable as per agreement. Amounts recoverable from the late partner should be debited to his capital account. Usual items are:-
 (a) Drawings up to the date of death
 (b) Interest on drawings
 (c) Loss on revaluation
 (d) Share of loss of the business

Following is a specimen of deceased partner's capital account:-

Balance b/d (if debit)	Balance b/d
Drawings	Current a/c
Interest on drawings	Profit & Loss suspense a/c
Current a/c (if debit)	Revaluation a/c
P & L suspense a/c (loss)	Reserve a/c
Revaluation a/c	Goodwill a/c
Goodwill a/c (reduction if any)	Joint life policy a/c
Executors of (deceased)	Salaries a/c
Loan a/c (transfer-bal. fig.)	Interest on capital

The above adjustments are made in the capital account of the deceased partner. The balance in the capital account is transferred to a loan account opened in the name of the executor of the deceased partner and the continuing partner will determine as to how the amount will be paid off. The agreement normally provides for the interest payable on the loan and the conditions for the repayment of such loan.

1. CALCULATION OF DECEASED'S SHARE OF PROFIT

The representative/executors of the deceased partner are entitled to the share of the profit earned by the firm from the date of the last balance sheet to the date of the death. This profit can be ascertained, properly, by preparing the final accounts on the date of death. But it involves stock taking and it may not be practicable in all the cases. Therefore, profit may be estimated on any one of the following basis, depending upon the agreement –

(a) ON TIME BASIS –

(i) Time Basis–Previous Year's Profit:

It is based on the presumption that current year's profit shall be at the same level at which it was in the previous year and profits accrue evenly throughout the year.

For example – Firm is having A, B and C as equal partners. Profit and loss account for the year ended December 31, 1993 revealed net profit of Rs. 36,000. A dies on March 31, 1994. Calculate A's share of profit based on previous year's profit.

Solution:

Total profit during 1993 = Rs. 36,000

Proportionate profit for 3 months (i.e. from Jan. 1 to March 31)

= 36,000 × 3 ÷ 12 = 9,000

A's share (one third) = 9,000 ÷ 3 = Rs. 3,000

(ii) Time Basis – Average Profit of Certain Years:

In some cases agreement may provide that basis of calculating the profit should be the average profits of number of years then such calculation shall be made accordingly.

For Example

A, B and C are partners sharing profits in the ratio of 5 : 3 : 2. Agreement provides that deceased partner's share of profit shall be calculated on the basis of average profits of the previous three years. A dies on 30th April 1994. The profits for the year 1991, 1992 and 1993 were Rs. 32,000; 40,000 and 36,000 respectively. Calculate A's share of profit.

Solution:

Profit (total) 3 years = 32,000 + 40,000 + 36,000 = Rs. 1,08,000

Average yearly profit = 1,08,000 ÷ 3 = Rs. 36,000

Profit for 4 months (Jan. 1 to April 30) = 36,000 ÷ 12 × 4 = 12,000

(b) ON SALES BASIS:

Partnership agreement may provide that deceased partner's share of profit for the current year up to the date of his death shall be calculated on the basis of sales. For this purpose it is necessary to know the figures of sales and profit of the previous year and sales figure of the current period up to the date of death.

For Example

X, Y and Z are partners sharing profits in the ratio 4 : 5 : 7. X dies on 31st March 1994. The sales and profit during 1993 were Rs. 2,40,000 and Rs. 60,000 respectively. The sales up to March 31, 1994 amounted to Rs. 80,000. Calculate X's share profit.

Solution:

If sale is worth Rs. 2,40,000 then profit is = 60,000

when sale is worth Re. 1 profit = $60,000 \div 2,40,000$

when sale is worth Rs. 80,000 profit = $60,000 + 2,40,000 \times 80,000$

= Rs. 20,000

X's capital share = $20,000 \times 4 \div 16$ = Rs. 5,000

2. CALCULATION OF INTEREST ON DECEASED'S CAPITAL

In case where as per agreement partners capital balances are entitled for interest it is only fair that deceased's capital should be entitled for similar interest from the opening day of the year to the date of death. For example, if the balance of deceased partner's capital on January 1, 1993 was Rs. 1,00,000 and he died on June 30, 1993 and interest on capital is allowed at the rate of 10 % per annum then interest for 6 months shall be –

$$1,00,000 \times \frac{10}{100} \times \frac{6}{12} = \text{Rs. } 5,000$$

The necessary journal entry is –

Interest on capital account	Dr.	5,000	
Deceased partner's capital account			5,000

3. CALCULATION OF DECEASED'S SHARE IN ACCUMULATED PROFITS/RESERVES

Accumulated and undistributed profits appear on the liability side of the balance sheet under the name of General reserve or Reserve fund or Contingency reserve etc., Actually these represent retained earnings and belong to all partners in their profit sharing proportion. So, at the time of death deceased partner's share shall be credited to his capital account. The necessary journal entry is –

General reserve/Contingency reserve	Dr.
Capital accounts of ... (partner)	

4. CALCULATION OF DECEASED'S SHARE IN GOODWILL

Value of the goodwill of the firm is valued as per the provisions of the partnership deed and deceased's share is credited to his capital account.

JOURNAL ENTRY

Goodwill account Dr.

Deceased partner's capital account

If it is desired that goodwill should be raised to its full value then credit is given to all the partners in their profit sharing ratio.

ILLUSTRATION NO. 33

A, B and C were partners sharing profits in the ratio of 4 : 3 : 1. Partnership deed provides that on the death of any partner his share of goodwill is to be valued at twice the net profits credited to his account during the previous 5 years. Books are closed on December 31, ever year. B died on January 1, 1994. Firm's profits for the previous five years were as follows:

1989 Rs. 12,000 **1990 Rs. 14,000**

1991 Rs. 6,000 (loss) **1992 Rs. 20,000**

1993 Rs. 24,000

(1) Calculate the amount to be credited to B on account of goodwill.

(2) Pass the necessary journal entry without raising goodwill account. Future profit sharing ratio of A and C is 3 : 2.

Solution:

B's share of goodwill

Previous five years profits of the firm

= 12,000 + 14,000 − 6,000 + 20,000 + 24,000 = Rs. 64,000

B's share of profit = 64,000 × 3 ÷ 8 = Rs. 24,000

∴ B's share of goodwill = 24,000 × 2 = Rs. 48,000.

	A's capital account Dr.		12,800	
	C's capital account Dr.		35,200	
	B's capital account			48,000
	(Being B's share of goodwill debited to A and C in gaining ratio i.e. 4 : 11)			

GAINING RATIO:

	New ratio – old ratio	=	Gaining ratio
A	$\frac{3}{5} - \frac{4}{8}$	$\frac{24-20}{40}$	$= \frac{4}{40}$
C	$\frac{2}{5} - \frac{1}{8}$	$\frac{16-5}{40}$	$= \frac{11}{40}$

Thus the gaining ratio is 4 : 11.

ILLUSTRATION NO. 34

X, Y and Z were partners sharing profits and losses in the ratio of 5 : 3 : 2 respectively. On 31st December, 1990 their Balance sheet stood as under:

Assets	*Rs.*	*Liabilities*		*Rs.*
Building	**50,000**	**Sundry creditors**		**15,000**
Patents	**15,000**	**Reserve fund**		**15,000**
Machinery	**75,000**	**Capital accounts:**		
Stock	**25,000**	**X**	**75,000**	
Debtors	**20,000**	**Y**	**62,500**	
Cash at bank	**20,000**	**Z**	**37,500**	**1,75,000**
	2,05,000			**2,05,000**

Z died on 1st May 1991. It was agreed that

(a) **Goodwill be valued at 2.5 years' purchase of the average profits of the last four years, which were – 1987 Rs. 32,500; 1988 Rs. 30,000; 1989 Rs. 40,000 and 1990 Rs. 37,500.**

(b) **Machinery be valued at Rs. 70,000; Patents at Rs. 20,000 and building at Rs. 62,500.**

(c) **For the purpose of calculating Z's share in the profits of 1991, the profits in 1991 should be taken to have been earned on the same scale as in 1990.**

(d) **A sum of Rs. 10,500 is to be paid immediately to the executors' of Z and the balance to be paid in four equal half–yearly installments together with interest @ 10 % per annum.**

Give the necessary journal entries to record the above transactions and Z's executors' account for the year 1991.

Solution:

Working Notes:

1. Goodwill's valuation:

   Total profits of previous four years

   = 32,500 + 30,000 + 40,000 + 37,500 = 1,40,000

   Average profits = 1,40,000 ÷ 4 = 35,000

   Goodwill (2.5 years purchase) = 35,000 × 2.5 = Rs. 87,500

   To be credited to X (5/10) = 43,750

   Y (3/10) = 26,250

   Z (2/10) = 17,500

2. Z's share of profit:

   Yearly profit of the firm (1990 base) = 37,500

   Four months profit = 37,500 ÷ 12 × 4 = 12,500

   Z's share = 12,500 × 2 ÷ 10 = 2,500

JOURNAL

				Dr. Rs.	Cr. Rs.
1991					
May 1	Goodwill account	Dr.		75,000	
	X's capital account				37500
	Y's capital account				2500
	Z's capital account				15000
	(Being goodwill raised and credited to partners in their profit sharing ratio)				
	Profit & Loss suspense account	Dr.		2,500	
	Z's capital account				2,500
	(Being profit's share up to the death credited)				
	Revaluation account	Dr.		5,000	
	Machinery account				5,000
	(Being machinery revalued as per agreement)				
	Patents account	Dr.		5,000	
	Building account	Dr.		12,500	
	Revaluation account				17,500
	(Being assets revalued as per agreement)				

	Revaluation account Dr.	125,00	
	X's capital account		6,250
	Y's capital account		3750
	Z's capital account		2500
	(Being reserve credited to partners)		
	Reserve fund account Dr.	15000	
	X's Capital account		7500
	Y's Capital account		4500
	Z's Capital account		3000
	(Being reserve credited to partners)		
	Z's capital account Dr.	63,000	
	Executors of Z(deceased)'s loan account		63,000
	(Being amount due to Z transferred to executors loan account)		

EXECUTOR'S OF Z (DECEASED)'S LOAN ACCOUNT

Dr. Cr.

1991		Rs.	1991		Rs.
May 1	Bank account	10,500	May 1	Z's capital account	60,000
Oct. 31	Bank account	15,750	Oct. 31	Interest	5,625
Dec. 31	Balance c/d	39,375		(52,500 × 10 % × 1/2)	
		65,625			65,625

NOTE:

	Rs.
Total amount payable to Z's executors	63,000
Payment to be made immediately	10,500
	52,500

Each half yearly installment = 52500 ÷ 4 = Rs. 13,125

So, the payment on October 31, 1991 –

	Rs.
Installment	13,125
Add Interest	2,625
	15,750

JOINT LIFE POLICY

On the death of a partner, the firm becomes liable to pay the executors of deceased partner his capital, interest on capital, his share of profit from the closing of the previous year to the date of death and his share of reserves, goodwill etc. The total amount thus becoming due to the executors is usually significant and immediate payment of such heavy amount out of firm's resources is likely to affect firm's finances very adversely.

The above problem can be tackled if the firm takes policy on the lives of all the partners jointly from insurance company. According to the terms of the policy, the premium is paid, periodically by the firm to the insurance company who undertakes to pay the sum assured to the firm either on the death of any partner or on the maturity of the policy which ever is earlier. The amount received is credited to all the partners including the deceased in their profit sharing ratio while the amount received enables the firm to make the payment to the executors without affecting adversely the financial position of the firm.

Following are the various methods for the treatment of joint life policy in the books of the firm.

ACCOUNTING TEATMENT OF JOINT LIFE POLICY

(A) When premium is treated as business expenditure

Under the first method the premium paid for the policy is treated as a business expense and is written off to the profit and loss account. The effect of this method is that the cost of insurance premium is charged to the partners in the proportions in which they share profits and losses. The method suffers from the drawback that the premium paid under the system cannot be considered as a business expense incurred in the ordinary course of its business. Moreover, the policy account does not appear in the books and hence is not shown in the balance sheet of the concern. The value of the policy, however, represents a secret reserve which belongs to the partners in the profit sharing ratio.

The following entries are passed under this method:

(a) On payment of premium every year

Premium on joint life policy account Dr.

Bank

(b) For closing the premium account by transfer to profit and loss account

Profit and loss account Dr.

Premium on joint life policy account

(c) On receipt of policy money on the death of a partner

Bank account Dr.

Joint life policy account

(d) For crediting the policy money amount to the partners in their profit sharing ratio

Joint life policy account Dr.

Partners capital accounts

(B) When premium is treated as on asset

Under the second method, a joint life policy account is opened in the books and the premium as and when they are paid are debited to this account. The book value of the policy is adjusted to its surrender value by transfer of the excess to the profit and loss account. Thus, the joint life policy account appears in the books of the concern at realizable value and is shown as an asset in the balance sheet. On the death of a partner the policy amount along with the bonus received from the insurance company will be credited to the joint life policy account. The account is now closed by transfer to the capital accounts of the partners including the deceased partner in their profit sharing ratio.

The various entries under the method are:

(a) For recording the payment of premium

Joint life policy account Dr.

  Bank

(b) For adjusting the value of policy to its surrender value

Profit and loss account Dr.

  Joint life policy account

(c) For recording the receipt of policy money on the death of a partner

Bank account Dr.

  Joint life policy account

(d) For closing the policy account by transfer to the capital accounts in the profit sharing ratio

Joint life policy account Dr.

  Partners capital accounts

(C) When premium is treated as asset and joint life policy account is maintained

Under the third method, the premium paid is debited to the joint life policy account. At the end of each year, a sum equal to the amount of annual premium paid is debited to the profit and loss account and credited to the joint life policy reserve account. The book value of the policy is adjusted to its surrender value by a transfer of the excess amount over the surrender value from the joint life policy account to the joint life policy reserve account. On the death of a partner, the sum received under the policy will be credited to the joint life policy account. The existing balance in the joint life policy reserve account will be closed by transfer to the joint life policy account. The latter account will now be closed by transfer to the capital accounts of the partners in their profits sharing ratio. This method has the advantages of disclosing the existence of the assets at its realizable value and also of avoiding the danger of depleting working capital of the firm.

Various journal entries passed under this method are as follows:

(a) ***For recording the payment of premium –***

Joint life policy account Dr.

Bank account

(b) ***For appropriating the premium –***

Profit & loss appropriation account Dr.

Joint life policy reserve account

(c) ***For adjustment the policy value to its surrender value –***

Joint life policy reserve account Dr.

Joint life policy account

(d) ***For receipt of insurance amount on maturity or death –***

Bank account Dr.

Joint life policy account

(e) ***For closing joint life policy reserve account –***

Joint life policy reserve account Dr.

Joint life policy account

(f) ***For closing joint life policy account –***

Joint life policy account Dr.

Partners' capital accounts

ILLUSTRATION NO. 35

A, B and C sharing profits and losses in the ratio of 5 : 3 : 2 took out a joint like policy for Rs. 50,000 paying an annual premium of Rs. 4,000 starting from January 1, 1991. Surrender value of the policy was as follows –

1991 Nil

1992 Rs. 2,000

1993 Rs. 6,000

On 1st November, 1993 A died and the insurance company paid Rs. 50,000. Accounts of the firm are closed on December 31, every year. Pass necessary journal entries and open necessary ledger accounts in the following cases:

(i) If premium paid is treated as an expense.

(ii) If premium paid is treated as an asset.

(iii) If premium paid is treated as an asset and joint life policy reserve account is maintained.

Solution:

(i) When premium is treated as business expenditure:

			Dr. Rs.	Cr. Rs.
1991				
Jan. 1	Premium on joint life policy account Dr.		4,000	
	Bank account			4,000
	(Being the payment of premium)			
Dec. 31	Profit & Loss account Dr.		4,000	
	Premium on joint life policy account			4,000
	(Being premium debited to profit & loss account)			
1992				
Jan. 1	Premium on joint life policy account Dr.		4,000	
	Bank account			4,000
	(Being the payment of premium)			
Dec. 31	Profit & loss account Dr.		4,000	
	Premium on joint life policy account			4,000
	(Being premium transferred to profit & loss a/c).			
1993				
Jan. 1	Premium on joint life policy account Dr.		4,000	
	Bank account			4,000
	(Being the premium paid)			
Nov. 1	Insurance company Dr.		50,000	
	Joint life policy account			50,000
	(Being policy amount due on A's death)			
Nov. 1	Bank account Dr.		50,000	
	Insurance company			50,000
	(Being sum assured received from company)			
Nov. 1	Joint life policy account Dr.		50,000	
	A's capital account			25,000
	B's capital account			15,000
	C's capital account			10,000
	(Being policy amount credited to partners in their profit ratio)			
Dec. 31	Profit & loss account Dr.		4,000	
	Premium on joint life policy account			4,000
	(Being premium charged to profit & loss account)			

PREMIUM ON JOINT LIFE POLICY ACCOUNT

Dr. Cr.

1991		Rs.	1991		Rs.
Jan. 1	Bank account	4,000	Dec. 31	Profit & loss account	4,000
1992					
Jan. 1	Bank account	4,000	Dec. 31	Profit & loss account	4,000
1993					
Jan. 1	Bank account	4,000	Dec. 31	Profit & loss account	4,000

JOINT LIFE POLICY ACCOUNT

1993		Rs.	1993	Rs.	
Nov. 1	A's capital account	25,000	Nov. 1	Insurance company	50,000
	B's capital account	15,000			
	C's capital account	10,000			
		50,000			50,000

(ii) When premium is treated as asset:

1991			Dr. Rs.	Cr. Rs.
Jan. 1	Joint life policy account	Dr.	4,000	
	Bank account			4,000
	(Being payment of premium)			
Dec. 31	Profit & loss account	Dr.	4,000	
	Joint life policy account			4,000
	(Being asset reduced to surrender value)			
1992				
Jan. 1	Joint life policy account	Dr.	4,000	
	Bank account			4,000
	(Being annual premium paid)			
Dec. 31	Profit & loss account	Dr.	2,000	
	Joint life policy account			2,000
	(Being asset reduced to surrender value)			

1993				
Jan. 1	Joint life policy account	Dr.	4,000	
	Bank account			4,000
	(Being premium paid)			
Nov. 1	Insurance company	Dr.	50,000	
	Joint life policy account			50,000
	(Being amount due on A's death)			
Nov. 1	Bank account	Dr.	50,000	
	Insurance company			50,000
	(Being policy amount received)			
	Joint life policy account	Dr.	44,000	
	A's capital account			22,000
	B's capital account			13,200
	C's capital account			8,800
	(Being profit on policy credited to all partners in their profit sharing ratio)			

JOINT LIFE POLICY ACCOUNT

1991		Rs.	1991		Rs.
	Bank account	4,000	Dec. 31	Profit & loss account	4,000
1992			1992		
Jan. 1	Bank account	4,000	Dec. 31	Profit & loss account	2,000
				Balance c/d	2,000
		4,000			4,000
1993			1993		
Jan. 1	Balance b/d	2,000	Nov. 1	Insurance company	50,000
	Bank account	4,000			
	A's capital account	22,000			
	B's capital account	13,200			
	C's capital account	8,800			
		50,000			50,000

(iii) Premium paid is treated as an asset and joint life policy reserve account is maintained:

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1991			Dr. Rs.	Cr. Rs.
Jan. 1	Joint life policy account	Dr.	4,000	
	Bank account			4,000
	(Being the payment of premium)			
Dec. 31	Profit & Loss appropriation account	Dr.	4,000	
	Joint life policy reserve account			4,000
	(Being premium appropriated)			
Dec. 31	Joint life policy reserve account	Dr.	4,000	
	Joint life policy account			4,000
	(Being asset reduced to its surrender value)			
1992				
Jan. 1	Joint life policy account	Dr.	4,000	
	Bank account			4,000
	(Being the payment of premium)			
Dec. 31	Profit & loss appropriation account	Dr.	4,000	
	Joint life policy reserve account			4,000
	(Being premium appropriated)			
Dec. 31	Joint life policy reserve account	Dr.	2,000	
	Joint life policy account			2,000
	(Being policy reduced to surrender value)			
1993				
Jan. 1	Joint life policy account	Dr.	4,000	
	Bank account			4,000
	(Being annual premium paid)			

Nov. 1	Insurance company	Dr.	50,000	
	Joint life policy account			50,000
	(Being amount due on policy due to A's death)			
	Bank account	Dr.	50,000	
	Insurance company			50,000
	(Being amount received on policy)			
	Joint life policy reserve account	Dr.	2,000	
	Joint life policy account			2,000
	(Being reserve account closed)			
	Joint life policy account	Dr.	46,000	
	A's Capital account			23,000
	B's Capital account			13,800
	C's Capital account			9,200
	(Being profit on joint life policy credited to all partners capitals in their profit sharing ratio)			

Dr. **JOINT LIFE POLICY ACCOUNT** Cr.

1991		Rs.	1991		Rs.
Jan. 1	Bank account	4,000	Dec. 31	Joint life policy reserve	4,000
1992			1992		
Jan. 1	Bank account	4,000	Dec. 31	Joint life policy reserve	2,000
				Balance c/d	2,000
		4,000			4,000
1993			1993		
Jan. 1	Balance b/d	2,000	Nov. 1	Insurance company	50,000
	Bank account	4,000		Joint life policy reserve	2,000
	A's capital account	23,000			
	B's capital account	13,800			
	C's capital account	9,200			
		52,000			52,000

JOINT LIFE POLICY RESERVE ACCOUNT

1991		Rs.	1991		Rs.
Dec. 31	Joint life policy a/c	4,000	Dec. 31	Profit & loss appropriation	4,000
1992			1992		
Dec. 31	Joint life policy a/c	2,000	Dec. 31	Profit & loss appropriation	4,000
	Balance c/d	2,000			
		4,000			4,000
1993			1993		
Nov. 1	Joint life policy a/c	2,000	Jan. 1	Balance b/d	2,000

INDIVIDUAL LIFE POLICIES

Firm may adopt a policy of getting separate insurance cover on the life of each of the partners. However, in this case also the premium on the life of each partner's policy share be paid by the firm. On the death of any partner only one policy mature and full amount insured on that policy shall be recovered from the insurance company. But other policies' surrender value shall be taken into account while calculating amount due to the executors of deceased partner.

Thus the executors of deceased partners shall be entitled to his share in (i) his policy and (ii) surrender value of other policies.

ILLUSTRATION NO. 36

X, Y and Z are equal partners. Firm has taken life policies on their lives individually. They have been insured for Rs. 12,000, Rs. 15,000 and Rs. 18,000 respectively. Y dies. On the date of Y's death the surrender value of all the policies is 40 % of the sum assured. Calculate Y's share on the life policies.

Solution:

Y's share on his own policy $= 15{,}000 \div 3 =$	Rs. 5,000
On X's policy $= 12{,}000 \times \frac{40}{100} \times \frac{1}{3} =$	1,600
On Z's policy $= 18{,}000 \times \frac{40}{100} \times \frac{1}{3} =$	2,400
	9,000

ILLUSTRATION NO. 37

X, Y and Z were partners sharing profit and losses in the proportion of two–third, one–sixth and one–sixth respectively. Balance sheet of the firm as on December 31, 1992 was as follows:

Assets	*Rs.*	*Liabilities*	*Rs.*
Cash	10,000	Sundry creditors	15,000
Debtors	15,000	Capital:	
Stock	15,000	X	40,000
Premises	30,000	Y	10,000
X's loan	5,000	Z	10,000
	75,000		75,000

X died on January 1, 1993. Firm had taken joint life policy of Rs. 30,000. Policy amount was realized on January 15, 1993. As per partnership deed goodwill was valued at 2 years' purchase of average profits of three completed years. Deceased partner was paid out his dues on February 1, 1993, available cash balance being supplemented by a bank loan from the firm's bankers. Profits for the preceding three years were Rs. 20,000, Rs. 20,000 and Rs. 23,000 respectively.

You are required to show the ledger accounts of the partners and the Balance Sheet of Y and Z as it would stand after X's death. (Ignore interest).

Solution:

Dr. X'S CAPITAL ACCOUNT Cr.

1993		Rs.	1993		Rs.
Jan. 1	X's loan a/c	5,000	Jan. 1	Balance b/d	40,000
Feb.	Cash a/c	40,000	Jan. 15	Joint life policy	20,000
Feb. 1	Bank loan a/c	43,000	Jan. 15	Goodwill account	28,000
		88,000			88,000

Y'S CAPITAL ACCOUNT

1993		Rs.	1993		Rs.
Feb. 1	Balance c/d	15,000	Jan. 1	Balance b/d	10,000
			Jan. 15	Joint life policy a/c	5,000
		15,000			15,000

Z'S CAPITAL ACCOUNT

1993		Rs.	1993		Rs.
Feb. 1	Balance c/d	15,000	Jan. 1	Balance b/d	10,000
			Jan. 15	Joint life policy a/c	5,000
		15,000			15,000

BALANCE SHEET
as on February 1, 1993

Assets	*Rs.*	*Liabilities*	*Rs.*
Debtors	15,000	Creditors	15,000
Stock	15,000	Bank loan	43,000
Premises	30,000	Capitals:	
Goodwill	28,000	Y	15,000
		Z	15,000
	88,000		88,000

PARTNERSHIP ACCOUNTS (III DISSOLUTION OF THE FIRM

Partnership, as a form of business organization, is a voluntary association of persons to carry on business. It comes into existence as a result of agreement between partners. Similarly it can be dissolved if and when partners decide, mutually, to discontinue it. According to Partnership Act 1932, "the dissolution of partnership between all the partners of a firm is called dissolution of the firm". It implies complete breakdown of the relation of partnership between all the partners. Business activity comes to an end. Firm's books of accounts are closed. Assets are realized, liabilities are paid off or settled and partners claims are also settled.

DISTINCTION BETWEEN DISSOLUTION OF PARTNERSHIP AND PARTNERSHIP FIRM

The dissolution of partnership does not necessarily involve dissolution of the firm whereas dissolution of firm involves dissolution of partnership also. Every change in the agreement between partners dissolves the partnership but not the firm. Firm may continue its business under the same name and style on the basis of new agreement. Admission, retirement or death of any partner or even change in the profit sharing ratio of the partners where the firm continues its business is the dissolution of partnership but not the dissolution of the firm.

The dissolution of partnership is its reconstitution and reorganization which continues under the old name and style.

Dissolution of the firm may be caused as per the agreement among partners i.e. voluntary dissolution. It may be compulsory dissolution or dissolution by the court.

MODES OF DISSOLUTION OF A FIRM

A firm may be dissolved either with or without the intervention of the court.

1. ***Dissolution by agreement:***

A firm may be dissolved with the consent of all the partners in accordance with a contract between the partners.

2. ***Compulsory dissolution or dissolution by the operation of law:***

A firm is compulsorily dissolved:

(a) by the adjudication as insolvent of all the partners or of all the partners but one, or,

(b) by the happening of any event which makes it unlawful for the business of the firm to be carried on or for the partners to carry it on in partnership.

3. ***Dissolution on the happening of certain contingencies:***

Subject to contract between the partners, a firm can be dissolved:

(a) by the expiry of the term fixed.

(b) by the completion of the adventure or undertaking.

(c) by the death of a partner.

(d) by the insolvency of a partner.

4. ***Dissolution by notice of partnership at will:***

Where the partnership is at will, the firm may be dissolved by any partner giving notice in writing to all the other partners of his intention to dissolve the firm.

5. ***Dissolution by court:***

At the suit of a partner, the court may order the dissolution of the firm in any of the following ways:

(i) where a partner has become of unsound mind;

(ii) where a partner has become permanently incapable of performing his duties as a partner;

(iii) where a party is guilty of misconduct;

(iv) where a partner commits willful or persistent breaches of agreement;

(v) where a partner has transferred the whole of his interest in the firm to a third party;

(vi) where the business of the firm cannot be carried on save at a loss;

(vii) where on any other ground the court is satisfied that it is just and equitable that the firm should be dissolved.

SETTLEMENT OF ACCOUNTS ON DISSOLUTION:

Partnership Act 1932 provides that subject to an agreement by the partners, the accounts of a firm on dissolution must be settled according to the following rules:

(a) Losses suffered by the firm shall be paid —

first out of profits,

next, out of capital, and

lastly, if necessary by the partners individually in the proportion in which they were entitled to share profits.

(b) The assets of the firm, including the contributions of the partners are to be distributed in the following order:

(i) in paying the debts due to third parties;

(ii) in paying the partners reteably advances made by them as distinguished from their contributions towards the capital;

(iii) in paying the partners reteably what is due to them on account of capital;

(iv) if there is any surplus, it shall be divided between the partners in the proportion in which they were entitled to share profits.

The above-cited legal position may be precisely mentioned, in simple language, as follows:

External debts shall be paid out of assets of the firm first and if any surplus is left the same shall be utilized for repayment of loans advanced by the partners and next the residue shall be applied among the partners for the repayment of capitals and if still the surplus is left it shall be distributed among partners as profit in their profit sharing ratio. However, in case of deficiency the deficiency of the insolvent partner is borne by the solvent partners in the ratio of their fixed capitals (as per Garner Vs Murray decision).

FIRM DEBTS V. PRIVATE DEBTS

Where there are partnership debts and separate debts of the partners the partnership property shall be applicable in the first instance in payment of the partnership debts and the separate property of each partner shall be applicable in the first instance in payment of his separate debts. Where there is a surplus of the separate property of the partners, it shall be dealt with as part of the partnership property and where there is a surplus of the partnership property it shall be dealt with as part of the respective separate property in proportion to the rights and interests of each partner in the partnership property.

ACCOUNTING TREATMENT

As already discussed the dissolution amounts to stopping all the business activities of the firm therefore we are required to close the books of accounts of the firm.

On the date of dissolution the balance sheet of the firm is prepared. All the balances appearing in the balance sheet are closed in the following manner.

1. ***For closing various assets accounts***

Realization account .... Dr. x x x

    Asset Account .... x x x

Note: Each asset account is credited individually. Cash and Bank accounts are not transferred. Since assets have debit balance therefore the effect of above entry is to close each asset account. If balance sheet shows profit and loss account and capital account on the assets side, these are also not transferred to realization account. Assets are transferred at book value i.e. the value at which these have been shown in the balance sheet. Unrecorded asset if any is not transferred to realization account.

2. ***For closing various liabilities accounts***

Liability account .... Dr. x x x

    Realization account .... x x x

Note: Each liability including provision against any asset is transferred individually. Since liabilities have credit balance so the effect of above entry is to close these accounts. However, following credit balances appearing in the balance sheet are not transferred.

(a) Partners' capital accounts

(b) Partners' current accounts

(c) Partners' loan account

Each liability is transferred at book value. Unrecorded liabilities are not transferred to the realization account.

Alternatively liability account may not to transferred to realization account. Payment made be debited to liability account. Difference, if any, between the book value and the amount actually paid to discharge the same is debited or credited to the realization account. Following illustrations will make this treatment clear.

ILLUSTRATION NO. 38

Balance sheet of the firm shows creditors at Rs. 25,000. Pass journal entries when it is directly paid at:

(a) book value

(b) Rs. 24,000

(c) Rs. 26,000

Solution:

				Rs.	Rs.
(a)	Creditors account	Dr.		25,000	
	Cash account				25,000
(b)	Creditors account	Dr.		25,000	
	Cash account				24,000
	Realization account				1,000
(c)	Creditors account	Dr.		25,000	
	Realization account	Dr.		1,000	
	Cash account				26,000

3. ***For sale or disposal or auction of an asset***

Cash/Bank account .... Dr. x x x

Realization account .... x x x

Note: This entry passed with the actual amount received including the amount received on the sale of unrecorded assets.

4. ***For assets taken over by a partner***

Partner's capital account ....Dr. x x x

Realization account .... x x x

Note: This entry is passed with the amount agreed at which the partner taken over a particular asset.

5. ***For payment of liabilities (through realization)***

Realization account ....Dr. x x x

Cash/Bank account .... x x x

Note: The above entry is passed with the actual amount paid for discharging the liabilities.

SETTLEMENT OF CREDITORS BY TRANSFER OF ASSETS:

In some cases creditors might accept some asset of the firm as part payment towards their claim. For example, creditors worth Rs. 30,000 accept investments of the book value of Rs. 25,000 and Rs. 5,000 in cash in discharge of their claim the journal entry required is:

Realization account	...............................Dr.	5,000	
Cash/Bank account	....		5,000

Note: There is no need to record exchange of investments because that account has already been closed by its transfer to realization account. In fact, the debit or asset cancels the credit of corresponding liability.

In the above case if it is assumed that creditors accept an asset which has more value than the claim and difference is paid by the creditor in cash e.g., Creditors claim Rs. 30,000; investment accepted having book value Rs. 35,000 and cash paid by the creditor to the firm Rs. 5,000 then the required entry is:

Cash account	...............................Dr.	5,000	
Realization account	....		5,000

In case where creditor accepts any asset in full and final settlement no entry is required.

6. ***For payment of unrecorded liability***

When unrecorded liability has to be paid such as outstanding repair bill, damages etc., then the required entry is:

Realization account ....Dr. x x x

Cash account .... x x x

7. ***For sale of unrecorded asset***

If any asset of the firm which does not appear in the firm's balance sheet is disposed off the amount realized is recorded as:

Cash account ....Dr. x x x

Realization account .... x x x

8. ***For liabilities taken over by a partner***

Realization account .... Dr. x x x

Partner's capital account .... x x x

Note: This entry shall be passed with the agreed amount at which the liability has been taken over by a partner.

9. ***For transfer of undivided profits***

Profit loss account .... Dr. x x x

Partner's capital account .... x x x

Note: This entry shall be passed with the balance shown by profit and loss account in the balance sheet and credit shall be given to all the partners in their profit sharing ratio. Similarly treatment is given to reserves etc., appearing on the liability side of the balance sheet.

10. ***For expenses of realization***

Realization account .... Dr. x x x

Cash account .... x x x

Note: The entry is passed with the amount spent on the process of realization.

11. ***For transferring loss on realization***

Partner's capital accounts .... Dr. x x x

Realization account .... x x x

Note: In case debit side of realization account is showing bigger total the difference is loss on realization and the same is credited to the realization account and debited to all partners capital accounts in their profit sharing ratio.

12. ***For transferring profit on realization***

Realization account .... Dr. x x x

Partner's capital account .... x x x

The profit on realization is credited to all partners in their profit sharing ratio.

13. ***For repayment of partners capital balance***

Partner's capital account .... Dr. x x x

Cash/Bank account .... x x x

After making all the adjustments in the capital accounts the balance remaining is paid off and the above entry is passed.

14. ***For amount brought in by partners***

In case where any partner's capital account is showing the debit balance such partner shall pay to the firm amount due by him. Journal entry is:

Cash/Bank account .... Dr. x x x

Partner's capital account .... x x x

15. For repayment of partner's loan

Partner's loan account .... Dr. x x x

Bank account .... x x x

Note: The above entry is not required if partner's loan account was closed by transfer to realization account.

PREPARATION OF REALISATION ACCOUNT

Accounting for dissolution is carried through a special account named as Realization account. This account is debited with all the assets at book values (except cash and bank); is credited with all the liabilities at book values (except partners loan, capitals and reserves etc.) in the first instance. Next it is debited with the amount paid off for settlement of liabilities; expenses of realization and it is credited with the amount realized on disposal of assets. Difference representing profit/loss on realization is transferred to capital accounts of all the partners in their profit sharing ratio. The specimen of realization account appears below:.

REALISATION ACCOUNT

(Specimen)

Dr. Cr.

	Items		Item
(1)	Bills receivable	(1)	Sundry Creditors
	Stock		Bills payable
	Investments		Bank loan
	Land & building	(2)	Provision for bad debts
	Plant & machinery	(3)	Joint life policy reserve
	Sundry debtors	(4)	Depreciation fund/reserve
	Joint life policy	(5)	Investment fluctuation fund
	Vehicles		
(2)	Cash/Bank:-	(6)	Cash/Bank
	Payment of creditors		(assets realized)
	Payment of bills payable	(7)	Partner's capital
(3)	Payment of unrecorded liability		(asset taken over)
(4)	Cash:	(8)	Partners capital accounts
	Realization expenses		(loss transferred)
(5)	Partner's capital: liability assumed		
(6)	Partner's capital accounts profit transferred)		

TREATMENT OF GOODWILL

Goodwill may or may not appear in the balance sheet on the date of the dissolution of the firm. If it appears in the balance sheet like any other asset it would be closed by transfer to the debit side of realization account. If it does not appear on the assets side of the balance sheet, then on the sale of goodwill, the amount realized would be debited to the cash or bank account and credited to realization account. If, however, a partner decides to carry on the business, he will have to pay a sum, as agreed upon, for goodwill which would be debited to his capital account and credited to realization account.

NOTES ON REALISATION ACCOUNT

DEBIT SIDE

Item (1) Each asset is individually transferred at book value i.e. the value appearing in the balance sheet. However, cash, bank, profit & loss account and partner's current accounts are not transferred.

Item (2) Payment made by the firm for settlement of liabilities is recorded at the actual amount paid.

Item (3) Payment may have to be made for unrecorded liabilities, contingent liabilities. Actual amount paid is recorded here.

Item (4) In the process of dissolution of firm expenses incurred are known as dissolution/dissolution expenses. Actual expenditure is recorded.

Item (5) Any partner may agree to assume any liability of the firm i.e. he undertakes to discharge the liability of the firm. With the agreed value the capital account is credited.

Item (6) Difference in dissolution account when credit side is bigger than debit side represents profit on realization is credited to partners' capital accounts in their profit sharing ratio.

CREIDT SIDE

Item (1) Liabilities like creditors, bills payable, bank overdraft etc. are transferred at book value.

Item (2) Reserve or provision for bad and doubtful debts against sundry debtors or bills receivable appearing in the balance sheet are transferred at book value.

Item (3) Joint life policy reserve is maintained against joint life policy, it is credited to realization account.

Item (4) Provision for depreciation maintained against assets is credited to realization account.

Item (5) This fund is maintained to meet the loss arising due to decrease in the value of investment. It is also closed through realization account.

However, it may be noted that item number 2 to 5 does not represent any liability so no payment shall be made against these items.

Item (6) Actual amount realized from the sale of assets is recorded here.

Item (7) Any asset taken over by any partner is recorded here at the value agreed.

Item (8) Excess of debit over credit side of the realization account representing loss on realization is debited to capital accounts of the partners in their profit sharing ratio.

PARTNERS' CAPITAL ACCOUNTS

Each partner's capital account will show opening balance as per the last balance sheet. The same shall be credited with:

(a) profit on realization

(b) any liability assumed

(c) undistributed profit, reserves etc.,

It shall be debited with:

(a) loss on realization

(b) any asset taken over

(c) debit balance on current account if any

(d) debit balance shown by profit and loss account.

After the above adjustments the capital account is closed by means of Cash/Bank account. If amount is recoverable from the partner the entry is debit Cash/Bank and credit capital account. In case the amount is payable to the partner by the firm then entry is:

Capital account	Dr. x x x	
Cash/Bank account		x x x

PARTNER'S LOAN ACCOUNT

Partner may have advanced loan (in addition to capital) to the firm, in such a case partner's loan account will show credit balance. At the time of repayment the entry is:

Partner's loan account	Dr. x x x	
Cash/Bank account		x x x

On the other hand if partner's loan account is showing debit balance (i.e. partner has obtained loan from the firm) it will be recovered and the entry is:

Cash/Bank account	Dr. x x x	
Partner's loan account		x x x

CASH/BANK ACCOUNT

In the case of dissolution of a partnership firm the account shall be closed at the end of all. It is advised to open one account for "cash and bank".

The account will have debit balance as per balance sheet. Amount realized from realization of assets, any amount realized from unrecorded asset and amount brought in by any partner for balancing his capital account shall be debited to this account. The account shall be credited by the amount paid for discharge of liabilities; payment of unrecorded liability, payment of realization expenses and payment to the partners by way of refund of their capital due. All this will close the account automatically. Thus no balance shall be left in this account.

ILLUSTRATION NO. 39

A and B are partners sharing profits equally. Balance sheet on September 30, 1993 was as follows:

Assets		Rs.	Liabilities		Rs.
Bank		3,500	Creditors		11,200
Stock		17,800	Bills payable		1,800
Debtors	13,800		A's loan		5,000
Less provision	1,400	12,400	Reserve fund		6,000
Furniture		2,800	Capital accounts:		
Plant and machinery		22,500	A	15,000	
			B	20,000	35,000
		59,000			59,000

Firm dissolved on the above date. Assets realized as under:

	Rs.
Stock	18,200
Debtors	10,600
Furniture	1,800
Plant & Machinery	19,000

Creditors allowed a discount of 2 % and expenses of realization amounted to Rs. 544.

Close the books of the firm.

Solution:

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1993			Dr. Rs.	Cr. Rs.
Sep. 30	Realization account Dr.		56,900	
	Stock account			17,800
	Debtors account			13,800
	Furniture account			2,800
	Plant & Machinery account			22,500
	(Being transfer of sundry assets)			

	Provision for doubtful debts account	Dr.	1,400	
	Creditors	Dr.	11,200	
	Bills payable	Dr.	1,800	
	Realization account			14,400
	(Being transfer of liabilities)			
	Bank account	Dr.	49,600	
	Realization account			49,600
	(Being amount realized on sale of assets)			
	Realization account	Dr.	12,776	
	Bank account			12,776
	(Being discharge of liabilities)			
	Realization account	Dr.	544	
	Bank account			544
	(Being payment of realization expenses)			
	A's Capital account	Dr.	3,110	
	B's Capital account	Dr.	3,110	
	Realization account			6,220
	(Being loss on realization debited)			
	A's Loan account	Dr.	5,000	
	Bank account			5,000
	(Being repayment of A's loan)			
	Reserve fund	Dr.	6,000	
	A's capital account			3,000
	B's capital account			3,000
	(Being reserve credited in profit ratio)			
	A's Capital account	Dr.	14,890	
	B's Capital account	Dr.	19,890	
	Bank account			34,780
	(Being amount due to partners paid off)			

Dr. **REALISATION ACCOUNT** Cr.

	Rs.			Rs.
Stock	17,800	Provision for bad debts		1,400
Debtors	13,800	Creditors		11,200
Furniture	2,800	Bills payable		1,800
Plant and Machinery	22,500	***Bank:***		
Bank:		Stock	18,200	
Creditors	10,976	Debtors	10,600	
Bills payable	1,800	Furniture	1,800	
Expenses	544	Plant & Machinery	19,000	49,600
		Capital accounts:		
		A	3,110	
		B	3,110	6,220
	70,220			70,220

A'S LOAN ACCOUNT

	Rs.		Rs.
Bank account	5,000	Balance b/d	5,000

A'S CAPITAL ACCOUNT

	Rs.		Rs.
Realization account (loss)	3,110	Balance b/d	15,000
Bank account	14,890	Reserve fund	3,000
	18,000		18,000

B'S CAPITAL ACCOUNT

	Rs.		Rs.
Realization account (loss)	3,110	Balance b/d	20,000
Bank account	19,890	Reserve fund	3,000
	23,000		23,000

BANK ACCOUNT

	Rs.		Rs.
Balance b/d	3,500	Realization account:	
Realization account (assets realized)	49,600	Creditors	10,976
		Bills payable	1,800
		Expenses	544
		A's loan account	5,000
		A's capital account	14,890
		B's capital account	19,890
	53,100		53,100

WORKING NOTES:

		Rs.
1.	Calculation of payment to creditors:	
	Amount due	11,200
	Less discount allowed 2 % on 11,200	224
	Net amount	10,976

2. Payment of A's loan has been made directly without transferred it to realization account.

TREATMENT OF REALISATION EXPENSES

Process of dissolving a firm will require some expenses. Such expenses are known as realization or liquidation or winding up expenses and are usually, debited to realization account and credited to cash/bank account.

In case such expenses are paid by a particular partner, his capital account is credited and realization account is debited.

In some cases an agreed amount is credited to one partner on account of realization expenses irrespective of actual expenditure which he might have to incur. So only agreed amount shall be debited and credited to realization account and capital account respectively.

ILLUSTRATION NO. 40

Give the required journal entries relating to realization expenses in the following cases:

(i) Realization expenses amount to Rs. 1,800.

(ii) Realization expenses amounting to Rs. 700 paid by partner X.

(iii) It is agreed to pay an agreed amount of Rs. 1,200 to a partner Y as realization expenses. Actual expenditure met by him was Rs. 1,500.

(iv) Y was to meet realization expenses from his own pocket in lien of commission of Rs. 1,500.

Solution:

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			Dr. Rs.	Cr. Rs.
(i)	Realization account Dr.		1,800	
	Bank account			1,800
	(Being realization expenses paid)			
(ii)	Realization account Dr.		700	
	To X's capital account			700
	(Being firm's expenses met by X)			
(iii)	Realization account Dr.		1,200	
	Y's capital account			1,200
	(Being agreed amount credited to Y on account of realization expenses)			
(iv)	Realization account Dr.		1,500	
	Y's capital account			1,500
	(Being commission in lieu of realization expenses credited to Y)			

It is assumed that actual expenses have been paid by Y out of his own resources.

ILLUSTRATION NO. 41

A and B are equal partners in a firm. They decide to dissolve the partnership on 31st December 1990 when the state of their affairs was as under.

BALANCE SHEET
as at 31st December 1990

Assets	*Rs.*	*Liabilities*	*Rs.*
Cash at bank	**3,000**	**Sundry creditors**	**2,700**
Sundry debtors	**850**	**Reserve fund**	**3,000**
Plant	**4,700**	**A's loan account**	**3,000**
Stock	**15,150**	**Capital:**	
Leasehold premises	**6,000**	**A**	**12,000**
Furniture and fittings	**3,000**	**B**	**12,000**
	32,700		**32,700**

Assets were realized as follows:

	Rs.
Leasehold premises	**6,360**
Furniture and fittings	**3,300**
Stock	**13,800**
Sundry debtors	**800**
Plant	**4,800**

The creditors were paid Rs. 2,660 in full settlement. Expense of realization amounted to Rs. 500.

Prepare realization account, bank account and partners capital accounts to close the books of the firm.

Solution:

REALISATION ACCOUNT

Dr. **Cr.**

	Rs.			Rs.
Sundry debtors	850	Sundry creditors		2,700
Plant	4,700	***Bank:***		
Stock	15,150	Sundry debtors		800
Lasehold premises	6,000	Plant		4,800
Furniture & fittings	3,000	Stock		13,800
Bank (creditors)	2,660	Leasehold premises		6,360
Bank (expenses)	500	Furniture & fittings		3,300
		Capital accounts:		
		A	550	
		B	550	1,100
	32,860			**32,860**

A' S LOAN ACCOUNT

	Rs.		Rs.
Bank account	3,000	Balance b/d	3,000

A'S CAPITAL ACCOUNT

	Rs.		Rs.
Revaluation account	550	Balance b/d	12,000
Bank account (bal fig.)	12,950	Reserve account	1,500
	13,500		13,500

B'S CAPITAL ACCOUNT

	Rs.		Rs.
Revaluation account	550	Balance b/d	12,000
Bank account	12,950	Reserve account	1,500
	13,500		13,500

BANK ACCOUNT

	Rs.		Rs.
Balance b/d	3,000	**Realization account:**	
Realization account	29,060	Creditors	2,660
(assets realized)		Expenses	500
		A's loan account	3,000
		A's capital account	12,950
		B's capital account	12,950
	32,060		32,060

NOTE: (1) Reserve fund being accumulated profit has been credited to partner's capital accounts in the profit sharing ratio.

ILLUSTRATION NO. 42

A, B and C sharing profits in the proportion of 3:2:1 agreed upon dissolution of their partnership on 31st December 1992 on which date their balance sheet was as under:

Assets		*Rs.*	*Liabilities*		*Rs.*
Machinery		**40,500**	**Capital accounts:**		
Stock in trade		**7,550**	**A**	**40,000**	
Investments		**20,830**	**B**	**20,000**	**60,000**
Joint life policy		**14,400**	**Mrs. A loan**		**10,000**
Debtors	**9,300**		**Creditors**		**18,500**
Less: Provision for			**Life policy fund**		**14,000**
doubtful debts	**600**	**8,700**	**Investment fluctuation fund**		**6,000**
Current account C		**11,500**			
Cash at bank		**5,420**			
		1,08,500			**1,08,500**

The life policy is surrendered for Rs. 12,000. The investments are taken over by A for Rs. 17,500. A agrees to discharge his wife's loan. B taken over all the stocks at Rs. 7,000 and debtors amounting to Rs. 5,000 at Rs. 4,000. Machinery is sold for Rs. 55,000. The remaining debtors realize 50 % of book value. The expenses of realization amount to Rs. 600.

It is found that an investment not recorded in the books is worth Rs. 3,000. The same is taken over by one of the creditors at this value.

Show the necessary ledger accounts including the final accounts for the partners on the completion of the dissolution of the firm.

Solution:

Dr. REALISATION ACCOUNT Cr.

		Rs.			Rs.
Sundry assets:			Sundries:		
– Machinery	40,500		– Provision for doubtful		
– Stock in trade	7,550		debts	600	
– Investments	20,830		– Mrs. A loan account	10,000	
– Investments	20,830		– Creditors	18,500	
– Joint life policy	14,000		– Life policy fund	14,000	
– Debtors	9,300	92,180	– Investment fluctuation		
Bank			fund	6,000	49,100
– Expenses		600	Bank account:		
Bank			– Machinery	55,000	
– Creditors	18,500		– Joint life policy	12,000	
Less: Investment	3,000	15,500	– Debtors	2,150	69,150
A's Capital account			A's capital account:		
– Mrs. A's loan		10,000	– Investments		17,500
Profit on realization transferred			B's capital account:		
to capital accounts:			– Stock	7,000	
A	14,235		– Debtors	4,000	11,000
B	9,490				
C	4,745	28,470			
		1,46,750			1,46,750

BANK ACCOUNT

		Rs.		Rs.
Balance b/d		5,420	Realization account:	
Realization account:			– Expenses	600
– Machinery	55,000		Realization account:	
– Joint life policy	12,000		– Creditors	15,500
– Debtors	2,150	69,150	A's capital account	46,735
C's current account		6,755	B's capital account	18,490
		81,325		81,325

A'S CAPITAL ACCOUNT

	Rs.		Rs.
Realization account investments	17,500	Balance b/d	40,000
Bank account	46,735	Realization account–Mrs. A loan	10,000
		Realization account profit	14,235
	64,235		64,235

B'S CAPITAL ACCOUNT

		Rs.		Rs.
Realization account:			Balance b/d	20,000
– Stock	7,000		Realization account – profit	9,490
– Debtors	4,000	11,000		
Bank account		18,490		
		29,490		29,490

C'S CURRENT ACCOUNT

	Rs.		Rs.
Balance b/d	11,500	Realization account – profit	4,745
		Bank account	6,755
	11,500		11,500

WORKING NOTES:

(1) Credit balance on life policy fund and investment fluctuation fund do not represent outside liabilities. Therefore, no payment shall be made against these items. However, these accounts have been closed by transferring to realization account.

(2) Mrs. A's loan represents outside liability assumed by the partner. Hence it appears on both sides of the realization account.

ILLUSTRATION NO. 43

A, B and C commenced business on January 1, 1993. They agreed to share profits and losses in the ratio 2:2:1. Their capitals were Rs. 30,000; Rs. 22,500 and Rs. 15,000 respectively. During 1993 the firm earned a profit of Rs. 20,050. During the year the partner's drawings were A Rs. 7,000. B Rs. 6,250 and C Rs. 4,000.

They decided to dissolve the firm on December 31, 1993. The assets were sold for Rs. 75,000. Creditors amounting to Rs. 12,000 were paid off at a discount of 5 %. Expenses of realization amounted to Rs. 1,200. Prepare the necessary accounts showing the distribution of cash at bank and of the further cash brought in by any partner as the case requires.

Solution:

WORKING NOTE:

(1) Ascertaining of sundry assets on the date of dissolution by preparing balance sheet:

Assets	*Rs.*	*Liabilities*	*Rs.*
Drawings:		Capitals:	
A	7,000	A	30,000
B	6,250	B	22,500
C	4,000	C	15,000
Sundry assets	82,300	Profit & loss account	20,050
(balancing figure)		Creditors	12,000
	99,550		99,550

(2) Actual payment to creditors:

Rs. 12,000 – (5 % of 12,000) = Rs. 11,400

Dr. PROFIT AND LOSS ACCOUNT Cr.

	Rs.		Rs.
Capital accounts		Balance b/d	20,050
(profit transferred):			
A (2/5)	8,020		
B (2/5)	8,020		
C (1/5)	4,010		
	20,050		20,050

REALISATION ACCOUNT

	Rs.		Rs.
Sundry assets	82,300	Creditors	12,000
Bank account:		Bank account	
Creditors	11,400	(assets realized)	75,000
Expenses	1,200	Capital accounts	
		(loss transferred):	
		A	3,160
		B	3,160
		C	1,580
	94,900		94,900

Dr. **A'S CAPITAL ACCOUNT** Cr.

	Rs.		Rs.
Drawings account	7,000	Balance b/d	30,000
Realization account	3,160	Profit & loss account	8,020
Bank account	27,860		
	38,020		38,020

Dr. **B'S CAPITAL ACCOUNT** Cr.

	Rs.		Rs.
Drawings account	6,250	Balance b/d	22,500
Realization account	3,160	Profit & loss account	8,020
Bank account	21,110		
	30,520		30,520

Dr. **C'S CAPITAL ACCOUNT** Cr.

	Rs.		Rs.
Drawings account	4,000	Balance b/d	15,000
Realization account	1,580	Profit & loss account	4,010
Bank account	13,430		
	19,010		19,010

BANK ACCOUNT

	Rs.		Rs.
Realization account	75,000	Realization account:	
(assets realized)		Creditors	11,400
		Expenses	1,200
		Capital accounts:	
		A	27,860
		B	21,110
		C	13,430
	75,000		75,000

ILLUSTRATION NO. 44

A and B are partners in a firm sharing profits and losses in the ratio of 2:1. On 31st December, 1993 their balance sheet was as follows.

Assets		*Rs.*	*Liabilities*	*Rs.*
Cash in hand		**6,000**	**Bank overdraft**	**30,000**
Bank balance		**10,000**	**General reserve**	**54,000**
Sundry debtors	**26,000**		**Investment fluctuation fund**	**20,000**
Less: Provision for			**A's loan**	**36,000**
doubtful debts	**2,000**	**24,000**	**Capital account – A**	**50,000**
Investments		**40,000**		
Stock		**10,000**		
Furniture		**10,000**		
Building		**60,000**		
B's capital		**30,000**		
		1,90,000		**1,90,000**

On that date the partners decide to dissolve the firm. A took over investments at an agreed valuation of Rs. 35,000. Other assets were realized as follows:

Sundry debtors full amount, the firm could realize stock at 15 % less and furniture at 20 % less than the book values. Building was sold at Rs. 1,00,000.

Compensation to employees paid by the firm amounted to Rs. 10,000. This liability was not provided for in the above balance sheet.

You are required to close the books of the firm by preparing realization account, partners capital accounts and bank account.

Solution:

REALISATION ACCOUNT

Dr. **Cr.**

		Rs.			Rs.
Sundry debtors		26,000	Provision for debtors		2,000
Investments		40,000	Investment fluctuation fund		20,000
Stock		10,000	Bank account (assets realized):		
Furniture		10,000	Debtors	26,000	
Building		60,000	Stock	8,500	
Bank account		10,000	Furniture	8,000	
(employee's compensation)			Building	1,00,000	1,42,500
Capital accounts (profit)			A's capital account		35,000
A (2/3)	29,000		(investments taken over)		
B (1/3)	14,500	43,500			
		1,99,500			1,99,500

A'S LOAN ACCOUNT

	Rs.		Rs.
Bank account	36,000	Balance b/d	36,000

A'S CAPITAL ACCOUNT

	Rs.		Rs.
Realization account	35,000	Balance b/d	50,000
(investments taken over)		General reserve	36,000
Bank account	80,000	Realization account	29,000
	1,15,000		1,15,000

B'S CAPITAL ACCOUNT

	Rs.		Rs.
Balance b/d	30,000	General reserve	18,000
Bank account	2,500	Realization	14,500
	32,500		32,500

BANK ACCOUNT

	Rs.		Rs.
Balance b/d	10,000	Bank overdraft	30,000
Cash account	6,000	Realization account	10,000
Realization account	1,42,500	A's loan account	36,000
		B's capital account	80,000
		C's capital account	2,500
	1,58,500		1,58,500

WORKING NOTES:

(1) 'Cash in hand' and 'Bank overdraft' have been transferred to Bank account.

(2) Investment fluctuation fund has been closed by transfer to realization account. However, it represents no liability.

(3) General reserve has been credited to partners' capital accounts in their profit sharing ratio i.e. 2:1.

(4) A's loan has been paid off directly through bank account.

(5) Compensation paid to employees Rs. 10,000 is a case of unrecorded liability. Its payment has been recorded on the debit of realization and credit of bank account.

(6) B's capital account is shown in the balance sheet on asset side denoting debit balance.

(7) Amount realized from stock:

	Rs.
Book value	10,000
Less: 15 % of 10,000	1,500
	8,500

(8) Amount realized from furniture:

Book value	10,000
Less: 20 % of 10,000	2,000
	8,000

DISSOLUTION OF THE FIRM–WHEN ONE PARTNER IS INSOLVENT:- GARNER VS MURRAY:

When capital account of one of the partners shows debit balance and such partner is insolvent i.e., unable to satisfy his debt to the firm then this is the additional loss to be borne by the solvent partners Why so? Because liability of all the partners of the firm is unlimited. Now the question is that deficiency arising out of the insolvency of a partner is to be met by remaining solvent partner in what proportion? Before the decision in the Garner vs. Murray such a loss was treated at par with ordinary losses and on the same footing was shared by the solvent partners in their profit sharing proportion.

Decision in Garner vs. Murray: In this case it was ruled that ***in the absence of any agreement to the contrary,*** the deficiency on the insolvent partner's capital account must be borne by other solvent partners in proportion to their capitals, after each solvent partner has brought in cash equivalent to his own share of loss on realization.

The implications of the above decision are two:

(1) Solvent partners to bring cash equal to their respective share of loss on realization;

(2) Deficiency on the capital account of the insolvent partners to be shared by solvent partners in the ratio of their capitals just before dissolution.

It should be appreciated that the decision in Garner vs. Murray has provided different treatments for:

(1) Loss on realization — considered to be normal loss and therefore to be shared by all the partners (including insolvent partner) in their respective profit sharing ratio.

(2) Loss on account of deficiency (on the capital account) of insolvent partner — considered to be abnormal loss and therefore to be shared by solvent partners in the ratio of capitals just before dissolution.

FIXED AND FLUCTUATING CAPITALS

As the ratio in which insolvent partner's loss is to be borne by the solvent partners is the ratio of capitals just prior to dissolution according to Garner vs. Murray decision therefore it is essential to find out: "What were the capitals of the partners at the date of dissolution"?

If the capital accounts of the partners have been maintained on 'fixed amount method' then no adjustment is required. The insolvent partner's deficiency would be borne by the solvent partners in proportion to their respective capitals which have been agreed by the partners to be fixed amounts.

In nutshel if the capitals are fixed then that will be the ratio for sharing insolvent partner's deficiency.

If the capital accounts of the partners have been maintained on 'fluctuating amount method' then the balances on capital account should be adjusted for any losses or gains carried forward and appearing in the balance sheet (e.g., reserves, profit and loss account etc.) without adjusting the loss on realization. The resulting balances in the capital accounts will be the required ratio for sharing deficiency of insolvent partner.

However, it is submitted that the decision in Garner vs. Murray violates the principles of 'natural justice' and 'equity'. For instance, if a partner is having debit balance on his capital account on the relevant date (just prior to dissolution) he will not bear the loss on account of insolvent partner's deficiency even though he may be financially more sound as compared to other solvent partners.

ILLUSTRATION NO. 45

The partnership of A, B and C who are sharing profits and losses in the proportion of 4/9, 2/9 and 1/3 is dissolved on 1st April 1993. Their balance sheet on 31st March 1993 was as follows:

Assets	*Rs.*	*Liabilities*		*Rs.*
Cash in hand	1,500	Sundry creditors		4,500
Cash at bank	2,250	Bills payable		2,050
Bills receivable	2,800	A's loan		2,000
Investments	12,000	Capitals:		
Debtors	15,500	A	34,000	
Stock	9,700	B	23,000	
Furniture	1,850	C	1,500	58,500
Machinery	7,500	Reserve fund		6,300
Building	22,500	Profit and loss		2,250
	75,600			75,600

The assets realized — Investments 15 % less: Bills receivable and debtors Rs.14,100; Stock 25 % less; Furniture Rs. 1025; Machinery Rs. 4,300 and Buildings Rs.13,200. The cost of realisation was Rs. 300. All the liabilities were paid off. C becomes bankrupt and Rs. 512 only are received from his estate in full settlement of his indebtedness to the firm. Partners are paid off.

Show the realisation account and capital accounts of the partners (i) when the capitals of the partners are fixed amounts and (ii) when the capitals are not fixed.

Solution:

REALISATION ACCOUNT

Dr.		Rs.			Cr. Rs.
Sundry assets –			Sundry liabilities –		
Bills receivable	2,800		Sundry creditors	4,500	
Investments	12,000		Bills payable	2,050	6,550
Debtors	15,500		Bank —		
Stock	9,700		Investment	10,200	
Furniture	1,850		Bills receivable and debtors	14,100	
Machinery	7,500		Stock	7,275	
Buildings	22,500	71,850	Furniture	1,025	
Bank–Cost of realisation		300	Machinery	4,300	
Bank–Payment of liabilities		6,550	Buildings	13,200	50,100
			Loss on realisation transferred to capital accounts		
			A $\frac{4}{9}$	9,800	
			B $\frac{2}{9}$	4,900	
			C $\frac{1}{3}$	7,350	22,050
		78,700			78,700

(i) Where the capitals are fixed quantities.

CASH ACCOUNT

	Rs.		Rs.
Balance b/d		Realisation account	
– Cash in hand	1500.00	Payment to creditors and bills payable	6,550.00
– Cash at bank	2,250.00	Realisation account	
Realisation account		– Cost of realisation	300.00
– Assets realised	50,100.00	A's loan account	2,000.00
A's capital account (Realisation loss)	9,800.00	A's capital account	36,315.92
B's capital account (Realisation loss)	4,900.00	B's capital account	23,896.08
C's capital account	512.00		
	69,062.00		69,062.00

Dr. **A'S CAPITAL ACCOUNT** Cr.

	Rs.		Rs.
Realisation account – loss	9,800.00	Balance b/d	34,000.00
C's capital account	1,484.08	Reserve fund	2,800.00
Bank	36,315.92	Profit and loss account	1,000.00
		Bank account	9,800.00
	47,600.00		47,600.00

B'S CAPITAL ACCOUNT

	Rs.		Rs.
Realisation account	4,900.00	Balance b/d	23,000.00
C's capital account	1,003.92	Reserve fund	1,400.00
Bank account	23,896.08	Profit and loss account	500.00
		Bank account	4,900.00
	29,800.00		29,800.00

C'S CAPITAL ACCOUNT

	Rs.		Rs.
Realisation account	7,350.00	Balance b/d	1,500.00
		Reserve fund	2,100.00
		Profit and loss account	750.00
		Bank account	512.00
		A's capital 34/57th share	1,484.08
		B's capital 23/57th share	1,003.92
	7,350.00		7,350.00

(ii) Where the capitals are fluctuating quantities

CASH ACCOUNT

	Rs.		Rs.
Balance b/d		Realisation account	
– Cash in hand	1500.00	Payment to creditors and bills	
– Cash at bank	2,250.00	payable	6,550.00
Realisation account		Realisation account	
– Assets realised	50,100.00	– Cost of realisation	300.00
A's capital account		A's loan account	2,000.00
(Realisation loss)	9,800.00	A's capital account	36,300.05
B's capital account		B's capital account	23,911.95
(Realisation loss)	4,900.00		
C's capital account	512.00		
	69,062.00		69,062.00

Dr. A'S CAPITAL ACCOUNT Cr.

	Rs.		Rs.
Realisation account	9,800.00	Balance b/d	34,000.00
C's capital account	1,499.95	Reserve fund	2,800.00
Bank	36,300.05	Profit and loss account	1,000.00
		Bank account	9,800.00
	47,600.00		47,600.00

B'S CAPITAL ACCOUNT

	Rs.		Rs.
Realisation account	4,900.00	Balance b/d	23,000.00
C's capital account	988.05	Reserve fund	1,400.00
Bank account	23,911.95	Profit and loss account	500.00
		Bank account	4,900.00
	29,800.00		29,800.00

C'S CAPITAL ACCOUNT

	Rs.		Rs.
Realisation account	7,350.00	Balance b/d	1,500.00
		Reserve fund	2,100.00
		Profit and loss account	750.00
		Bank account	512.00
		Capital accounts:	
		A's 126/209th share	1,499.95
		B's 83/209th share	988.05
	7,350.00		7,350.00

ILLUSTRATION NO. 46

A, B and C being partners in a firm dealing in various accessories and sharing profits and losses 40 %, 30 % and 30 % respectively decided to dissolve and appoint B to realise the assets and distribute the proceeds. B is to receive 5 % of the amount realised from stock and debtors as his remuneration and is to bear all the expenses of realisation. The following is the balance sheet prepared by the firm as on the date of dissolution.

Assets		*Rs.*	*Liabilities*		*Rs.*
Cash		**1,500**	**Creditors**		**59,000**
	Rs.		**Capitals:**		
Debtors	**45,500**		**A**	**30,000**	
Less Provision	**2,500**	**43,000**	**B**	**20,000**	**50,000**
Stock		**60,000**			
C's overdrawn a/c		**4,500**			
		1,09,000			**1,09,000**

B reports the result of realisation as follows:

Debtors realise Rs. 35,000; stock Rs. 45,000; goodwill Rs. 2,000; creditors were paid Rs. 57,500 in full settlement, outstanding creditors Rs. 500 have also been paid. The expenses of realisation came to Rs. 600 which B met personally. A and B agree to receive from C Rs. 3,000 in full settlement of the firms claim against him.

Show the capital accounts, realisation account and cash account. (Apply Garner vs. Murray).

Solution:

REALISATION ACCOUNT

Dr.	Rs.			Cr. Rs.
Debtors	45,000	Provision for doubtful debts		2,500
Stock	60,000	Creditors		59,000
Bank – creditors	57,500	Bank		
Bank – outstanding		Debtors	35,000	
Creditors	500	Stock	45,000	
B's capital account		Goodwill	2,000	82,000
remuneration due	4,000	Loss on realisation		
		transferred to		
		A's capital a/c	9,600	
		B's capital a/c	7,200	
		C's capital a/c	7,200	24,000
	1,67,500			1,67,500

BANK ACCOUNT

		Rs.			Rs.
Balance b/d		1,500	Realisation account		
Realisation account			Creditors	57,500	
Debtors	35,000		Outstanding creditors	500	58,000
Stock	45,000		B's capital account		
Goodwill	2,000	82,000	Expenses of realisation		600
A's capital account	9,600		A's capital account		24,780
B's capital account	7,200		B's capital account		19,920
C's capital account	3,000	19,800			
		1,03,300			1,03,300

A'S CAPITAL ACCOUNT

	Rs.		Rs.
Realisation on account – loss	9,600	Balance b/d	30,000
C's capital account – deficiency	5,220	Bank	9,600
Bank	24,780		
	39,600		39,600

B'S CAPITAL ACCOUNT

	Rs.		Rs.
Realisation account – loss	7,200	Balance b/d	20,000
C's capital – deficiency	3,480	Realisation account –	
Bank–expenses of realisation	600	Remuneration	4,000
Bank	19,920	Bank	7,200
	31,200		31,200

C'S CAPITAL ACCOUNT

	Rs.		Rs.
Balance b/d	4,500	Bank	3,000
Realisation account – loss	7,200	A's capital account	
		(3/5th share)	5,220
		B's capital account	
		(2/5th share)	3,480
	11,700		11,700

ILLUSTRATION NO. 47

Partners, A, B, C share profits in the ratio of 2 : 1 : 2 respectively on 31st March 1993. They decided to dissolve the partnership. The Balance Sheet as on that date is given below:

Assets	*Rs.*	*Liabilities*	*Rs.*
Balance in Bank	**4,000**	**Sundry Creditors**	**40,000**
Other assets	**3,96,000**	**Capitals:**	
		A	**1,60,000**
		B	**1,60,000**
		C	**40,000**
	4,00,000		**4,00,000**

The assets realised Rs. 2,40,000 only, and realisation expenses were Rs. 10,000. C has been declared insolvent. C has no assets other than the capital stated above.

Show the capital accounts of the partners, before and after the decision of Garner Vs. Murray.

Solution:

REALISATION ACCOUNT

Dr.	Rs.			Cr. Rs.
Other assets	3,96,000	Creditor		40,000
Cash expenses	10,000	Cash (assets realised)		2,40,000
Cash (creditors)	40,000	Loss: of Realisation		
		A	66400	
		B	33200	
		C	66400	1,66,000
	4,46,000			4,46,000

Before the case in Garner Vs Murray:

A'S CAPITAL ACCOUNT

Dr.	Rs.		Cr. Rs.
Realisation loss	66,400	Balance b/d	1,60,000
C's Capital	17,600		
Cash	76,000		
	1,60,000		1,60,000

B'S CAPITAL ACCOUNT

Dr.	Rs.		Cr. Rs.
Realisation loss	33,200	Balance b/d	1,60,000
C's Capital	8,800		
Cash	1,18,000		
	1,60,000		1,60,000

C'S CAPITAL ACCOUNT

Dr.	Rs.			Cr. Rs.
Realisation loss	66,400	Balance b/d		40,000
		A's Capital	17,600	
		B's Capital	8,800	26,400
		(profit sharing ratio: 2:1)		
	66,400			66,400

Dr. **CASH ACCOUNT** Cr.

	Rs.		Rs.
Balance b/d	4,000	Realisation expenses liabilities	50,000
Realisation	2,40,000	A's Capital	76,000
		B's Capital	1,18,000
	2,44,000		2,44,000

After the case in Garner Vs Murray:

Dr. **A'S CAPITAL ACCOUNT** Cr.

	Rs.		Rs.
Realisation	66,400	Balance b/d	1,60,000
C's Capital	13,200	Cash (nominal entry)	66,400
Cash	1,46,800		
	2,26,400		2,26,400

Dr. **B'S CAPITAL ACCOUNT** Cr.

	Rs.		Rs.
Realisation a/c	33,200	Balance b/d	1,60,000
C's Capital	13,200	Cash (nominal entry)	33,200
Cash	1,46,800		
	1,93,200		1,93,200

Dr. **C'S CAPITAL ACCOUNT** Cr.

	Rs.			Rs.
Realisation a/c	66,400	Balance b/d		40,000
		A's Capital	13,200	
		B's Capital	13,200	26,400
		(Capital ratio 1:1)		
	66,400			66,400

Dr. **CASH ACCOUNT** Cr.

	Rs.		Rs.
Balance b/d	4,000	Realisation: Expenses &	
Realisation	2,40,000	Liabilities	50,000
A's Capital (nominal)	66,400	A's Capital	1,46,800
B's Capital (nominal)	33,200	B's Capital	1,46,800
	3,43,600		3,43,600

Real payment

A: 1,46,800 – 66,400 = 80,400

B: 1,46,800 – 33,200 = 1,13,600

NOTE: Before the Garner Vs Murray case; the debit balance of insolvent partner is shared by solvent partners in their profit sharing ratio (2:1).

After the case; the debit balance of insolvent partner is to be shared by solvent partners in their final capital ratio; (after writing the entry for bringing their share of realisation loss in cash) (1:1).

ILLUSTRATION NO. 48

The Balance Sheet of A, B, C and D (who shared profits and losses in the ratio of 4 : 3 : 2 : 1) was as follows on 31st March, 1994.

Assets	*Rs.*	*Liabilities*		*Rs.*
Cash	**1,000**	**Sundry Creditors**		**20,000**
Stock	**8,000**	**Capital:**	**Rs.**	
Debtors	**15,000**	**A**	**60,000**	
Plant & Equipment	**80,000**	**B**	**40,000**	
Goodwill	**20,000**	**C**	**6,000**	**1,06,000**
Capital: D	**2,000**			
	1,26,000			**1,26,000**

The partners decide to wind up the business as C and D become insolvent. A sum of Rs. 1,000 is realised from C's separate resources while D has no separate assets or liabilities.

Stock and debtors realise Rs. 4,000 and Rs. 9,000. Plant and equipment are sold for Rs. 50,000 while Goodwill is valueless. The costs of realisation amount to Rs. 6,000 while sundry creditors have to be paid their claims in full. One of the creditors for Rs. 6,000 in the books of the firm actually claimed Rs. 12,000 and his claim was finally settled at Rs. 10,000 by arbitration.

Close the books of the firm by showing the relevant important Ledger Accounts.

Solution:

REALISATION ACCOUNT

		Rs.			Rs.
Stock		8,000	Sundry Creditors		20,000
Debtors		15,000	Cash (Assets Realised):		
Plant & Equipment		80,000	Stock	4,000	
Goodwill		20,000	Debtors	9,000	
Cash(Cost of Realisation)		6,000	Plant & Equipment	50,000	63,000
Cash (Creditors)	20,000		Loss on Realisation transferred to Capital Accounts:		
Add: Excess Amount to be paid to one creditor (10,000 – 6,000)	4,000	24,000	A – 4/10 share	28,000	
			B – 3/10 share	21,000	
			C – 2/10 share	14,000	
			D – 1/10 share	7,000	70,000
		1,53,000			1,53,000

A'S CAPITAL ACCOUNT

	Rs.		Rs.
Realisation A/c (Loss)	28,000	Balance b/d	60,000
C's Capital A/c (Deficiency)	4,200		
D's Capital A/c (Deficiency)	5,400		
Cash Account	22,400		
	60,000		60,000

B'S CAPITAL ACCOUNT

	Rs.		Rs.
Realisation A/c (Loss)	21,000	Balance b/d	40,000
C's Capital A/c (Deficiency)	2,800		
D's Capital A/c (Deficiency)	3,600		
Cash Account	12,600		
	40,000		40,000

C'S CAPITAL ACCOUNT

		Rs.			Rs.
	Realisation A/c (Loss)	14,000		Balance b/d	6,000
				Cash Account	1,000
				A's Capital A/c (3/5 share of deficiency)	4,200
				B's Capital A/c (2/5 share of deficiency)	2,800
		14,000			14,000

D'S CAPITAL ACCOUNT

		Rs.			Rs.
	Balance b/d	2,000		A's Capital A/c (3/5 share of deficiency)	5,400
	Realisation A/c (Loss)	7,000		B's Capital A/c (2/5 share of deficiency)	3,600
		9,000			9,000

CASH ACCOUNT

		Rs.			Rs.
	Balance b/d	1,000		Realisation A/c (Expenses)	6,000
	Realisation A/c (Assets Realised)	63,000		Realisation A/c (Creditors)	24,000
	C's Capital Account	1,000		A's Capital A/c	22,400
				B's Capital A/c	12,600
		65,000			65,000

Note:

A large majority of the accountants are of the view that the second ruling given in the Garner vs. Murray case is a useless ruling. The argument advanced by them against this ruling is that it is unreasonable to ask a solvent partner to bring in cash his share of loss on realisation when he already has a credit balance in his capital account. The only point to be kept in mind is that the deficiency of the insolvency partner should be borne by the solvent partners in proportion to their capitals which stood before debiting the loss on realisation.

DISSOLUTION OF THE FIRM–WHEN ALL THE PARTNERS ARE INSOLVENT:

When all the partners are insolvent and are not able to bring the amount due from them then the creditors of the firm cannot be paid in full. In such a case, the creditors of the firm will be paid all the cash available, together with whatever can be received from the private properties of the partners, after the expenses of realisation are met.

The resultant loss will have to be borne by the creditors. There are two methods to close the books of the firm in case all the partners are insolvent.

FIRST METHOD:

Under this method creditors are not transferred to realisation account. Creditors account will be debited with the amount of cash paid to them. Any amount remaining unpaid will be transferred to Deficiency Account. Capital Accounts of the partners will be prepared in the usual manner. As partners are insolvent, they cannot make up the deficiency in their accounts (cannot bring cash to meet their debit balances). Balances of the capital accounts will be transferred to Deficiency Accounts for final clossure of the books of the firm.

SECOND METHOD:

Under this method creditors account will be transferred to Realisation Account in the usual manner. Any cash paid to creditors will be debited to Realisation Account instead of creditors account. Thus any deficiency on account of less payment to creditors is automatically adjusted through Realisation Account. Finally debit and credit balances of capital accounts will be equal and capital accounts will be closed by mutual transfer of balances of capital accounts.

ILLUSTRATION NO. 49

Below is the Balance Sheet of M/s X, Y and Z as on September 30, 1994.

	Rs.		Rs.
Cash	**1,000**	**Sundry Creditors**	**40.000**
Stock	**24,000**	**X's Loan**	**12,000**
Debtors	**20,000**	**Capital Accounts:**	
Furniture	**5,000**	**X**	**5,000**
Z's Capital – Overdrawn	**10,000**	**Y**	**3,000**
	60,000		**60,000**

Owing to the inability to pay the creditors, the firm is dissolved. Y and Z cannot pay anything. X can contribute only Rs. 1,500 from his private estate. Stock realizes Rs. 15,000, Debtors realise Rs. 16,000 and Furniture is sold for Rs. 1,500. Expenses amount to Rs. 3,000. Prepare accounts to close the books of the firm.

Solution:

REALISATION ACCOUNT

Dr.		Rs.	Cr.		Rs.
Sundry Assets –			Cash Account:		
Stock	24,000		Stock	15,000	
Debtors	20,000		Debtors	16,000	
Furniture	5,000	49,000	Furniture	1,500	32,500
Realisation Account –			Loss transferred to:		
Expenses		3,000	X	6,500	
			Y	6,500	
			Z	6,500	19,500
		52,000			52,000

SUNDRY CREDITORS ACCOUNT

	Rs.		Rs.
Cash	32,000	Balance b/d	40,000
Deficiency/unpaid A/c balance transferred	8,000		
	40,000		40,000

CASH ACCOUNT

	Rs.		Rs.
Balance b/d	1,000	Realisation Account – Expenses	3,000
Realisation Account – Assets realised	32,500	Sundry Creditors (available cash paid to them)	32,000
X's Capital Account – Amount received from private estate	1,500		
	35,000		35,000

DEFICIENCY ACCOUNT

Dr.	Rs.	Cr.	Rs.
Y's Capital Account – Deficiency	3,500	Sundry Creditors – Amount unpaid	8,000
Z's Capital Account – Deficiency	16,500	X's Capital Account – Amount unpaid	12,000
	20,000		20,000

Dr. CAPITAL ACCOUNTS Cr.

	X	Y	Z		X	Y	Z
	Rs.	Rs.	Rs.		Rs.	Rs.	Rs.
Balance b/d	—	—	10,000	Balance b/d	5,000	3,000	—
Loss on Realisation	6,500	6,500	6,500	X's Loan Account	12,000	—	—
Deficiency A/c –				Cash Account	1,500	—	—
Transfer	12,000	—	—	Deficiency A/c			
				– Transfer	—	3,500	16,500
	18,500	6,500	16,500		18,500	6,500	16,500

GRADUAL REALISATION OF ASSETS AND PIECEMEAL DISTRIBUTION

In the above cases of dissolution we had assumed that all assets are realised on the date of dissolution and the accounts of all the creditors and partners are settled on the same date. But this assumption is unrealistic. Normally the process of realizing the assets of a dissolved firm takes a very long time. It may be advantageous to sell the assets over a period of time rather than to force an immediate sale.

Therefore when the process of winding up of a partnership business and the consequent realisation of the assets is likely to take considerable time the partners naturally desire that the net proceeds as and when realised should be distributed to them periodically on account of their shares in respect of their capitals. If pending the ascertainment of the total loss on realisation payments are made to the partners there is the risk of the over payment being made to one or more of them. In order to avoid the risk of over payments being made, the periodical distribution of cash should be made in such a way that the unpaid balance of the capitals of each partner is retained in his profit sharing ratio. The interim payments of the partners should be of such an amount that even though the remaining assets prove to be worthless no partner will have received more than the amount to which he is ultimately found to be entitled after being debited with his proper share of total loss sustained on realisation of all the assets.

On a gradual realisation of assets, the cash realised should be paid in the following order:

1. To meet the expenses of realisation.
2. To pay the external liabilities of the firm in full in priority to the claims of the partners either in respect of their loans or capitals. Where claims are due to different creditors (for instance trade creditors and bills payable) the amount due to them should be paid reteably.
3. After payment to creditors, the amount due to a partner as loan should be paid. Where loans are due to more than one partner the cash available should be paid reteably.
4. After the payment of external liabilities and loans due to the partners, the capitals of the partners have to be repaid.

PROPORTIONATE CAPITALS

Regarding to the return of capital to the partners the important point for consideration is the ratio in which the capitals have to be repaid. It will depend upon as to whether the capitals of the partners are or are not in the profit sharing ratio. If the capitals of the partners are in the profit sharing ratio, the payment must be made in the same ratio. But where the capitals are not in the profit sharing ratio, and the payments to the partners are made in the profit sharing ratio, the amount finally unpaid would not be in the profit sharing ratio. Also where the amount is distributed in the ratio of capitals then the amount unpaid would be in the ratio of capitals which may be quite different from the profit sharing ratio. Thus where the capitals of the partners are not in the profit sharing ratio, payments to the partners either in the profit sharing ratio or in the ratio of capitals will not leave the unpaid capitals in the profit sharing ratio. An example would make the point clear. For example, let us suppose that X and Y are partners with capitals of Rs. 25,000 and Rs. 15,000 and share the profits and losses in the ratio of 3 : 2. If after the payment to creditors Rs. 20,000 and Rs. 10,000 are realised, the distribution if made according to the profit sharing ratio would give the following result.

	X	X
Profit sharing ratio	3	2
	Rs.	Rs.
Capitals	25,000	15,000
First installment Rs. 20,000 divided in the ratio of 3:2	– 12,000	– 8,000
Balance due	13,000	7,000
Second installment Rs. 10,000 divided in the ratio of 3:2	– 6,000	– 4,000
Balance left unpaid or loss	7,000	3,000

The balance remaining unpaid i.e. Rs. 7,000 in the case of X and Rs. 3,000 in the case of Y is not in the profit sharing ratio. Hence the distribution of cash in the profit sharing ratio is wrong.

The following would be the position if the amount is distributed in the ratio of capitals.

	X	X
	Rs.	Rs.
Capitals	25,000	15,000
First installment Rs. 20,000 divided in the ratio of 5:3	– 12,500	– 7,500
Balance due	12,500	7,500
Second installment Rs. 10,000 divided in the ratio of 5:3	– 6,250	– 3,750
Balance left unpaid or loss	6,250	3,750

The balance remaining unpaid i.e. Rs. 6,250 in the case of X and Rs. 3,750 in the case of Y is not again in the profit sharing ratio. Hence distribution of cash in the ratio of capitals is wrong.

From the above we can conclude, that if the capitals of the partners are not in the profit sharing ratio then the payments made either in the ratio of capitals or in the profit sharing ratio will leave the unpaid balance (i.e. losses) in a ratio different from the profit sharing ratio. The question which naturally arises is, in what ratio should the available cash be distributed so that the net loss is, in the profit sharing ratio? Evidently any method can be adopted whereby the resultant loss to the partners is in the profit sharing ratio. The following principles in this regard would help.

1. Where the capital of the partners are in the profit sharing ratio, the available cash should be distributed in the same proportion.

2. Where the capitals of the partners are not in the profit sharing ratio, their capitals should be reduced or brought up, as the case may be, to the same proportions as their profit sharing ratio. It means that payment should be made first to the partner whose capital is proportionately greater in comparison with his share in the profit of the firm, until the excess capital thus ascertained is paid off. After the capitals of all the partners have been adjusted in the profit sharing proportions, the subsequent cash proceeds should be distributed among all the partners in their profit sharing ratio.

In our above illustration the capitals of X and Y are Rs. 25,000 and Rs. 15,000 respectively whereas they are sharing profits and losses in the ratio of 3 : 2. Therefore, if Y's capital is Rs. 15,000 X's capital (taking Y's capital as the base) should be Rs. 15,000 × $\frac{3}{2}$. i.e., Rs. 22,500. Hence Rs. 2,500 which is the excess capital of X over his due proportion of profits should be paid to him. The balance of X's capital i.e. Rs. 22,500 (Rs. 25,000 – Rs. 2,500) and Y's capital Rs. 15,000 are now in the profit sharing ratio. Therefore, the subsequent cash realizations can be distributed in the ratio of 3 : 2 i.e. in their profit sharing ratio. The distribution of cash would be as under:

	X	Y
	Rs.	Rs.
Capitals	25,000	15,000
First installment Rs. 20,000 Rs. 2,500 paid to X	– 2,500	—
Balance due	22,500	15,000
Rs. 17,500 paid to X and Y in the ratio of 3 : 2	– 10,500	– 7,000
Balance due	12,000	8,000
Rs. 10,000 paid to X and Y in the ratio of 3 : 2	– 6,000	– 4,000
Balance left unpaid or loss	6,000	4,000

The balance remaining unpaid i.e. loss Rs. 6,000 in the case of X and Rs. 4,000 in the case of Y are in the profit sharing ratio.

ILLUSTRATION NO. 50

A, B and C were in partnership sharing profits and losses in proportion to their respective capitals. They agreed to dissolve the partnership on 30th June 1992, at which date their assets and liabilities were as under.

Assets	Rs.	Liabilities		Rs.
Bank	3,600	Creditors		38,000
Sundry debtors	69,000	Capital accounts:		
Stock	75,400	A	60,000	
Plant and machinery	25,000	B	45,000	
		C	30,000	1,35,000
	1,73,000			1,73,000

It was also agreed that after the creditors had been paid in full the net proceeds of realisation should be distributed monthly. By 15th July 1992, sufficient of the assets had been realised to permit the creditors being paid in full and they were, therefore, paid on the date. The gross proceeds of realisation were:

	Debtors	Plant and machinery	Stock	Expenses
July	30,000	10,000	37,000	3,000
August	20,000	8,500	23,000	2,000
September	10,000	—	—	1,000

At 30th September the only remaining assets were outstanding debtor's accounts amounting to Rs. 9,000 and it was mutually agreed that B should take them over at 50 % of their book value.

You are required to set out realisation account, the relevant part of the cash book, showing distribution to partner's capital account up to the close of the business.

Solution:

The cash available for distribution in each month has been calculated as follows:

Month	Debtors	Plant and machinery	Stock	Total	Expenses	Cash available
	Rs.	Rs.	Rs.	Rs.	Rs.	Rs.
July	30,000	10,000	37,000	77,000	3,000	74,000
August	20,000	8,500	23,000	51,500	2,000	49,500
Sept.	10,000	—	—	10,000	1,000	9,000

Since the partners share the profits and losses in proportion to capitals, the cash available would also be distributed in the same proportions.

STATEMENT SHOWING DISTRIBUTION OF CASH

	Creditors	A's capital	B's capital	C's capital
	Rs.	Rs.	Rs.	Rs.
Amount due	38,000	60,000	45,000	30,000
Cash in hand Rs. 3,600 paid to creditors	3,600	—	—	—
Balance sheet	34,400	60,000	45,000	30,000
First installment (Rs. 74,000, Rs. 34400 paid to creditors	34,400	—	—	—
Balance due	—	60,000	45,000	30,000
Rs. 39,600 distributed among the partners in the ratio of 4 : 3 : 2		– 17,600	– 13,200	– 8,800
Balance due		42,400	31,800	21,200
Second installment Rs. 49,500 distributed among the partners in the ratio of 4 : 3 : 2		– 22,000	– 16,500	– 11,000
Balance due		20,400	15,300	10,200
Third installment Rs. 13,500 distributed among the partners in the ratio of 4 : 3 : 2		– 6,000	– 4,500	– 3,000
Balance unpaid or loss		14,400	10,800	7,200

NOTE: The payment of Rs. 4,500 to B in the third installment will be in the form of debtors only.

Dr. **REALISATION ACCOUNT** Cr.

1992			Rs.	1992			Rs.
July 1	Sundry assets			July 31	Bank–assets realised		
	Debtors	69,000			Debtors	30,000	
	Stock	75,400			Plant & machinery	10,000	
	Plant & machinery	25,000	1,69,400		Stock	37,000	77,000
July 31	Bank – expenses		3,000	Aug. 31	Bank–assets realised		
Aug. 31	Bank expenses		2,000		Debtors	20,000	
Sep. 30	Bank expenses		1,000		Plant & machinery	8,500	
					Stock	23,000	51,500
				Sep. 30	Bank–assets realised		
					Debtors		10,000
					B's capital account		
					Debtors		4,500
					Loss transferred to capital accounts		
					A	14,400	
					B	10,800	
					C	7,200	32,400
			1,75,400				1,75,400

SUNDRY CREDITORS ACCOUNT

1992		Rs.	1992		Rs.
July 1	Bank	3,600	July 1	Balance b/d	38,000
July 31	Bank	34,400			
		38,000			38,000

CASH ACCOUNT

1992		Rs.	1992		Rs.
July 1	Balance b/d	3,600	July 1	Sundry creditors	3,600
July 31	Realisation account		July 31	Realisation account	
	Assets realised	77,000		Expenses	3,000
Aug. 31	Realisation account			Sundry creditors	34,400
	Assets realised	51,500		A's capital account	17,600
Sept.30	Realisation account			B's capital account	13,200
	Assets realised	10,000		C's capital account	8,800
			Aug. 31	Realisation account	
				Expenses	2,000
				A's capital account	22,000
				B's capital account	16,500
				C's capital account	11,000
			Sept. 30	Realisation account	
				Expenses	1,000
				A's capital account	6,000
				C's capital account	3,000
		1,42,100			1,42,100

A'S CAPITAL ACCOUNT

Dr. Cr.

1992		Rs.	1992		Rs.
July 31	Bank	17,600	July 1	Balance b/d	60,000
Aug. 31	Bank	22,000			
Sept.30	Bank	6,000			
"	Realisation account loss	14,400			
		60,000			60,000

B'S CAPITAL ACCOUNT

1992		Rs.	1992		Rs.
July 31	Bank	13,200	July 1	Balance b/d	45,000
Aug. 31	Bank	16,500			
Sept.30	Realisation account				
	Debtors	4,500			
	Realisation account loss	10,800			
		45,000			45,000

C'S CAPITAL ACCOUNT

1992		Rs.	1992		Rs.
July 31	Bank	8,800	July 1	Balance b/d	30,000
Aug. 31	Bank	11,000			
Sept.30	Bank	3,000			
"	Realisation a/c loss	7,200			
		30,000			30,000

ILLUSTRATION NO. 51

A, B and C share profits of a firm in the proportion $\frac{1}{2}$, $\frac{1}{4}$ and $\frac{1}{4}$ respectively. On the date of dissolution, their balance sheet showed as follows:

Assets	***Rs.***	***Liabilities***		***Rs.***
Sundry assets	**40,000**	**Creditors**		**14,000**
		A's capital	**10,000**	
		B's capital	**10,000**	
		C's capital	**6,000**	**26,000**
	40,000			**40,000**

The assets realised Rs. 34,000 which were received in installments of Rs. 14,000, Rs. 10,000 and Rs. 10,000. Show how the proceeds should be distributed.

Solution:

The capitals contributed by A, B and C are Rs. 10,000, Rs. 10,000 and Rs. 6,000 while they share profits and losses in the ratio of 2 : 1 : 1. It is evident that the capitals of the partners are not in the profit sharing proportions. A's capital is Rs. 10,000, hence proportionate capitals of B and C should have been Rs. 5,000 each. The capitals of B and C are in excess of A's capital by Rs. 5,000 and Rs. 1,000. Since B and C are equal partners, their capital should also be equal. B's capital is in excess of C's capital by Rs. 4,000, therefore B should be paid Rs. 4,000 before any amount is paid to C. After a payment of Rs. 4,000 to B, the capitals of B and C are proportionately in excess of the capital of A by Rs. 1,000 each. After B and C have been paid Rs. 1,000 each, the capitals of A, B and C are in profit sharing ratio and hence all subsequent cash realizations would be divided in the ratio 2 : 1 : 1.

The following statement indicates the distribution of cash:

STATEMENT SHOWING DISTRIBUTION OF CASH

	Creditors Rs.	A Rs.	B Rs.	C Rs.
Amount due	14,000	10,000	10,000	6,000
First installment Rs. 14,000 paid to creditors	14,000	—	—	—
Balance due	—	10,000	10,000	6,000
Second installment Rs. 4,000 paid to B	—	—	4,000	—
Balance due	—	10,000	6,000	6,000
Rs. 2,000 paid to B & C equally	—	—	1,000	1,000
Balance due		10,000	5,000	5,000
Rs. 4,000 paid to A, B & C in the ratio of 2:1:1		2,000	1,000	1,000
Balance due		8,000	4,000	4,000
Third installment Rs. 10,000 paid to A, B and C in the ratio of 2 : 1 : 1.		5,000	2,500	2,500
Balance unpaid or loss		3,000	1,500	1,500

QUESTIONS

1. Mention the important clauses relating to accounts which you would suggest for being included in a partnership deed.
2. What do you understand by fixed capitals and fluctuating capitals of partners.
3. Distinguish between fixed capitals and fluctuating capitals.
4. In the absence of partnership agreement how will the following matters be determined.
   (a) Interest on capital and on drawings
   (b) Interest on loan given by a partner
   (c) Sharing of profits and losses
   (d) Payment of salary to a partner.
5. What do you understand by Goodwill? Under what circumstances does it arise? Explain and illustrate the different methods of calculating goodwill.
6. What are the several occasions on which goodwill figures in the partnership accounts.
7. Define Goodwill and state the factors upon which it depends and the methods which may be adopted to evaluate it.
8. What is revaluation account? Why is prepared? Give journal entries that have to be passed regarding the revaluation of assets and liabilities on the admission of a new partner.
9. On the admission of a new partner what accounting entries are necessary when partners have decided to revalue assets and liabilities but to show them in the books at old values.
10. Describe the various methods of treating goodwill in the books of accounts of a partnership concern at the time of admission of a new partner with illustrations.
11. Define goodwill and explain its treatment in books of account on admission of a new partner.
    (a) where no goodwill account appears in the books and the new partner brings cash for his share of goodwill and
    (b) when goodwill account appears in the books at its full value and the new partner brings cash for his share of goodwill.
12. Distinguish between sacrificing ratio and gaining ratio.
13. What is memorandum revaluation account? What purpose does it serve? How does it differ from a revaluation account?
14. Discuss the different methods, in which goodwill is treated in the books of accounts in case of retirement of a partner.
15. Why is it necessary to revalue assets and liabilities of the firm in case of retirement of a partner? Explain.

16. How will you calculate the amount payable to retiring partner? Support your answer with specimen of retiring partner's capital account.

17. Explain the procedure of determining the amount payable to retiring partner, when he leaves the firm.

18. Mention the different ways in which the amount due to retiring partner is paid to him.

19. How will you calculate the share of the deceased partner in the following items:
    (a) Joint life policy
    (b) Accumulated profit
    (c) Goodwill

20. Discuss the different methods of treating joint life policy in the books of accounts with suitable illustration.

21. Discuss the alternative methods of recording joint life policy account in partnership books.

22. Enumerate the accounting problems at the time of retirement and death of a partner.

23. Explain the meaning of gaining ratio. In what respect it is different from sacrificing ratio?

24. Distinguish between sacrificing and gaining ratio among partners.

25. Explain the accounting treatment of profit or loss on revaluation of assets and liabilities in case of retirement of partner.

26. How will you calculate the share of profit payable to the executors of deceased partner.

27. Write short notes on:
    (a) Surrender value
    (b) Executor's Loan Account
    (c) Employees Provident Fund
    (d) Workmen Compensation Fund
    (e) Contingency Reserve.

28. What do you mean by dissolution of a firm? State how and under what circumstances a firm may be dissolved.

29. What is realisation account? How does it differ from revaluation account?

30. state the legal provision for adjusting losses and distributing assets on the dissolution of a partnership where no agreement to the contrary exists.

31. Examine the underlying principles of Garner versus Murray decision in the dissolution of partnership with suitable illustrations.

32. Explain the decision in Garner versus Murray. Does this decision apply to Pakistan?

33. If on dissolution all partners are declared insolvent, how the accounts of the firm will be settled?

34. What do you understand by 'Piecemeal distribution'? If the assets are realised gradually how the amount realised would be distributed amongst partners?

OBJECTIVE TYPE QUESTIONS

1. **State whether each of the following statements is true or false:**

(i) Partnership arises from status.

(ii) It is necessary to have a partnership agreement in writing.

(iii) The business of the firm can be conducted even by one partner.

(iv) At least three persons are necessary for forming a partnership.

(v) A partnership can be formed only for a legal business.

(vi) The right to share a profit is full proof of one being a partner.

(vii) The liability of partners is limited.

(viii) Partners are mutual agents of each other so far as the business of the firm goes.

(ix) In the absence of any agreement regarding profit sharing ratio, profit or loss must be shared equally.

(x) In the absence of profit sharing ratio profit and losses are shared in the capital ratio.

(xi) Interest on money advanced by a partner as loan to the firm shall be paid even if there are losses in the business.

(xii) Interest on drawings is always calculated for full year on total drawings.

(xiii) Change in the profit sharing ratio involves almost the same adjustments as those in case of the admission of a new partner.

(xiv) Under fixed capital method, any addition to capital will be shown in partner's capital account.

(xv) Current accounts of partners are maintained under fluctuating capital method.

(xvi) Interest on partner's capital is allowed @ 6 %.

In which of the following cases indicate the alternative which you consider to be correct?

(i) In the absence of an agreement profit and losses are divided by partners in the ratio of

  (a) capital

  (b) time devoted by each partner

  (c) equally.

(ii) In the absence of an agreement, interest on loan advanced by a partner to the firm is allowed at the rate of

  (a) six per cent

  (b) five per cent

  (c) twelve per cent.

(iii) In the absence of an agreement, partners shall

(a) be paid salaries

(b) not be paid salaries

(c) be paid salaries to those who work for the firm.

(iv) Current accounts of the partners should be opened when the capitals are

(a) fluctuating

(b) fixed

(c) either fixed or fluctuating.

(v) Where a partner is entitled to interest on capital subscribed by him, such interest will be payable

(a) only out of profits

(b) only out of capital

(c) out of profits or out of capital

(d) none of these.

(vi) The interest on partners capital accounts is to be credited to

(a) partners capital account

(b) profit and loss account

(c) interest account.

(vii) In the absence of any agreement to the contrary, the partners

(a) are entitled for 6 % interest on their capitals only when there are profits.

(b) are entitled for 9 % interest on their capitals, only when there are profits.

(c) are entitled for interest on capital at the bank rate, only when there are profits.

(d) are not entitled for any interest on their capitals.

(viii) When interest is to be allowed on the capitals of the partners, it is calculated on the

(a) capital in the beginning of the year

(b) capital at the end of the year

(c) capital at the end less drawings if any

(d) average capital.

(ix) The current account of a partner

(a) will always have a credit balance

(b) will always have a debit balance

(c) may have a debit balance or a credit balance.

Ans: *[(i) (c); (ii) (a); (iii) (b); (iv) (b); (v) (a); (vi) (a); (vii) (d); (viii) (b); (ix) (c)].*

3. In each of the following cases, indicate the correct alternative:

(i) A new partner may be admitted to a partnership

(a) with the consent of all the old partners

with the consent of any one of the partners

with the consent of two third of the old partners

(d) without consent of old partners.

(ii) X, Y and Z are partners in a firm. If B is to be admitted as a new partner

(a) old partnership has to be dissolved

(b) old firm has to be dissolved

(c) both old firm and partnership have to be dissolved

(d) neither firm nor partnership need to be dissolved.

(iii) The share of profit to a new partner in the future profits without any express agreement as to who will contribute to new partner's share of profit is implied that old partners contribute

(a) equally

(b) in proportion of their capital

(c) in their profit sharing ratio

(d) none of these.

(iv) Old profit sharing ratio minus new profit sharing ratio is equal to

(a) sacrificing ratio

(b) gaining ratio

(c) none of these.

(v) When the incoming partner pays the firm for goodwill in cash, the amount should be debited in firms books to

(a) goodwill account

(b) capital account of the incoming partner

(c) cash.

(vi) On the admission of a partner if the goodwill account is to be raised this should be debited to

(a) partners capital accounts

(b) goodwill account

(c) cash account.

(vii) At the time of admission of a new partner, goodwill raised should be written off in

(a) new profit sharing ratio

(b) old profit sharing ratio

(c) sacrificing ratio

(d) gaining ratio.

(viii) If the incoming partner is to bring his share of goodwill in cash, and there exists any balance in goodwill account, then this goodwill account is to be written off among old partners in

(a) new profit sharing ratio

(b) old profit sharing ratio

(c) sacrificing ratio.

(ix) On the admission of a new partner the decrease in the value of assets is debited to

(a) profit and loss adjustment account

(b) assets account

(c) old partners capital account.

(x) On the admission of a new partner the increase in the value of assets is debited to

(a) profit and loss adjustment account

(b) assets account

(c) old partners capital account.

(xi) If the adjustment in the value of assets under taken at the time of admission of a partner shows a profit, it should be credited to the capital accounts of

(a) the old partners in the new profit sharing ratio

(b) all partners in their new profit sharing ratio

(c) the old partners in their old profit sharing ratio.

(xii) At the time of admission of a partner, undistributed profit appearing in the balance sheet of the old firm should be transferred to capital accounts of

(a) old partners in the old profit sharing ratio

(b) old partners in the new profit sharing ratio

(c) all the partners in the new profit sharing ratio

(d) none of the above.

Ans: *[(i) (a); (ii) (a); (iii) (c); (iv) (a); (v) (c); (vi) (b); (vii) (a); (viii) (b); (ix) (a); (x) (b); (xi) (c); (xii) (a)]*

4. In each of the following cases, indicate the correct alternative:

(i) A and B who are partners sharing profits in the ratio of 3 : 1 and admit C to one-fourth share in the future profits, the profit ratio will be

(a) A $\frac{9}{16}$: B $\frac{3}{16}$: C $\frac{4}{16}$ (b) A $\frac{10}{16}$: B $\frac{2}{16}$: C $\frac{4}{16}$

(c) A $\frac{8}{16}$: B $\frac{4}{16}$: C $\frac{4}{16}$ (d) A $\frac{6}{16}$: B $\frac{6}{16}$: C $\frac{6}{16}$

(ii) A and B share profits in the ratio of $\frac{4}{5}$ and $\frac{1}{5}$, admit C to $\frac{1}{2}$ share, the profit sharing ratio of the new firm would be

(a) A $\frac{2}{10}$: B $\frac{3}{10}$: C $\frac{5}{10}$ (b) A $\frac{3}{10}$: B $\frac{2}{10}$: C $\frac{5}{10}$

(c) A $\frac{4}{10}$: B $\frac{1}{10}$: C $\frac{5}{10}$ (d) A $\frac{1}{10}$: B $\frac{4}{10}$: C $\frac{5}{10}$

(iii) X and Y shared profits in the ratio of 7 : 5. Z was admitted as a partner who is to get $\frac{1}{6}$ th share in profits. He acquires the share $\frac{1}{2}$ from X and $\frac{1}{8}$ th from Y. Calculate the new profit sharing ratio

(a) 13 : 7 : 4 (b) 12 : 8 : 4

(c) 10 : 10 : 4 (d) 8 : 12 : 4.

(iv) X and Y shared profit in ratio of 3 : 2. Z was admitted as a partner who gets $\frac{1}{5}$ th share. New profit sharing ratio, if he acquired $\frac{3}{20}$ th from X and $\frac{1}{20}$ th from Y would be

(a) 9 : 7 : 4 (b) 8 : 8 : 4

(c) 6 : 10 : 4 (d) 10 : 6 : 4

(v) X and Y who shared profit in the ratio of 3 : 1 respectively admit Z to one–fourth share in the future profits. Z acquired his share equally from X and Y. The new profit sharing would be

(a) 9 : 3 : 4 (b) 2 : 1 : 1

(c) 3 : 2 : 3 (d) 5 : 1 : 2

(vi) A, B and C share profit and losses in the ratio of 6 : 5 : 3. D is admitted into partnership for $\frac{1}{8}$ th share. The sacrificing ratio of A : B : C is

(a) equal (b) 6 : 5 : 3

(c) $\frac{5}{14}$: $\frac{4}{14}$: $\frac{3}{14}$ (d) none of these.

(vii) X and Y are sharing profits in the ratio of 4 : 3. Z joins and the new ratio among X, Y and Z is 7 : 4 : 3. The sacrificing ratio between X and Y will be

(a) equal (b) 4 : 3

(c) 2 : 1 (d) 1 : 2.

(viii) A and B are partners in the ratio of 2 : 1. They admit C for $\frac{1}{4}$ share who contributes Rs. 3,000 for his share of goodwill. The total value of the goodwill of the firm is

(a) Rs. 3,000 (b) Rs. 9,000

(c) Rs. 12,000 (d) Rs. 15,000

(ix) Goodwill of a firm of A and B is valued at Rs. 30,000. It is appearing in the books at Rs. 12,000. C is admitted to $\frac{1}{4}$ th share, what amount is supposed to bring for goodwill

(a) Rs. 3,000 (b) Rs. 4,500

(c) Rs. 7,500 (d) Rs. 10,500.

(x) A and B are partners in a business sharing profits in the ratio of 5 : 3. They admit C as a partner with $\frac{1}{4}$ share in the profits which he acquires $\frac{3}{4}$ from A and $\frac{1}{4}$ from B. He pays Rs. 8,000 for his share of goodwill. A and B will be credited by

(a) Rs. 5,000 and Rs. 3,000 respectively.

(b) Rs. 6,000 and Rs. 2,000 respectively.

(c) Rs. 4,000 each.

Ans: *[(i) a, (ii) c, (iii) a, (iv) a, (v) d, (vi) b, (vii) d, (viii) c, (ix) b, (x) b]*

A. Point out whether the following statements are true or false?

(i) New and gaining ratios between continuing partners are always the same.

(ii) The executors of deceased partner are entitled to receive a share in the profit for the period between the last financial statements to the date of death.

(iii) If goodwill account is raised at full value and written off 'continuing partners' Capital Accounts will be debited in the gaining ratio while writing off goodwill.

(iv) Continuing Partners' Capital Accounts will be debited in the gaining ratio, while writting off goodwill, if it is raised with retiring partners' share.

(v) Entire share of retiring partners may sometimes be acquired by one partner alone.

(vi) Profit or loss on revaluation is transferred to continuing partners' Capital Accounts only.

(vii) Retiring Partners' Capital Account will be debited while making payment of amount due to him.

(viii) Amount due to deceased partner is generally transferred to his Executor's Loan Account.

(ix) Unexpired insurance is an asset.

(x) Decrease in the provision for bad and doubtful debts is a gain.

Ans: *[True (ii), (iv), (v), (vii), (viii), (ix) and (x) False (i), (iii) and (vi)]*

B. Match the expressions in Columns A and B by pairing the serial number and alphabets:

	Column A		Column B
1.	Partners Loan	(a)	P/L Adjustment Account
2.	Loss in the Bus	(b)	Joint Life Policy
3.	Revaluation Account	(c)	Gaining ratio
4.	Death of a partner	(d)	6 % interest
5.	Continuing partners	(e)	Debit balane

Ans: *[1 (d), 2 (e), 3 (a), 4 (b), 5 (c)]*

C. Choose the correct alternative:

(i) In the case of retirement of a partner, full goodwill is credited to the accounts of:

(a) all partners (b) only retiring partner

(c) only remaining partners

(ii) If the adjustments in the value of assets at the time of retirement of a partner show a profit, it should be credited to the capital accounts of:

(a) all the old partners in their profit sharing ratio.

(b) the remaining partners in their new profit sharing ratio.

(c) the remaining partners in their old profit sharing ratio.

(iii) On the retirement of a partner any reserve built out of profits etc. should be transferred to the capital accounts of:

(a) all partners in the old profit sharing ratio.

(b) remaining partners in the new profit sharing ratio.

(c) neither the retiring partner nor the remaining partner.

(iv) Where any partner retires, and the remaining partners carry on the business with the firm's property without any final settlement of accounts, the outgoing partner is entitled to:

(a) interest at 6 % per annum of the amount due to him.

(b) such share of the profits as may be attributable to the use of his share of the firm's property.

(c) either of the above two at the option of the outgoing partner.

(d) interest at the rate of 5 % per annum of the amount due to him.

(v) On the death of a partner the amount of joint life policy should be credited to the capital accounts of:

(a) all partners including the deceased partner in their profit sharing ratio.

(b) remaining partners in the new profit sharing ratio.

(c) neither the deceased partner nor the remaining partners.

Ans: *[1 (a), 2 (a), 3 (a), 4 (c), 5 (a)]*

PROBLEMS

DISTRIBUTION OF PROFITS OR LOSS

1. A and B started business on 1.1.1994 with capitals of Rs. 60,000 and 40,000 respectively. During the year A introduced Rs. 10,000 to the firm as additional capital on 1.7.1994. They withdraw Rs. 500 p.m. for household expenses in lieu of profits. Interest on capital is to be allowed @ 10 %.

   Calculate the interest payable to A and B for the year ending 31.12.1994.

Ans: *[Interest on capital A Rs. 6,500, B Rs. 4,000]*

2. A and B are partners from 1st January, 1993 without any partnership agreement and they introduced capitals of Rs. 35,000 and Rs. 20,000 respectively. On 1st July, 1993 A advances Rs. 7,500 by way of loan to the firm without any agreement as to interest. The profit and loss account for the year 1993 discloses a profit of Rs. 8,225; but the partners cannot agree upon question of interest or upon the basis of division of profits. You are required to divide the profit between them giving reasons for your method.

Ans: *[Interest on A's loan Rs. 225; Share of profit A Rs. 4,000; B Rs. 4,000]*

3. A, B and C are partners with capitals of Rs. 20,000, Rs. 10,000 and Rs. 6,000, respectively and share profits and losses equally. The net profit for the year 1993 before charging interest on capital amounted to Rs. 10,800. Show the amount of each partner gain from the firm (a) if no interest is calculated on capital and (b) where 5 % interest on capital is brought into account, before adjustment of profits.

Ans: *[(a)Profit: A Rs. 3600â B Rs. 3600â C Rs. 3600*
(b)Profit: A Rs. 3000â B Rs. 3000â C Rs. 3000]

4. From the following trial balance of Black and White for the year ended 31st March, 1993 prepare the final accounts (Trading account, profit and loss account and balance sheet). Profits are to be divided two–third to Black and one–third to White. Stock in hand on March 31, 1993 was Rs. 4,807.

Dr. Balances		Cr. Balances	
Stock (April 1, 1992)	3,211	Rent received	420
Carriage	304	Discount	180
Purchases	28,825	Sales	33,059
Business premises	3,000	Commission	25
Salaries	500	Bills payable	1,540
Cash at bank	7,050	Sundry creditors	1,221
Returns inwards	125	Returns outwards	95
Bad debts	230	Bad debts reserve (April 1, 1992)	195
Sundry debtors	4,000	Black's capital	9,000
Rates and taxes	650	White's capital	4,500
Wages	2,340		

Wages outstanding Rs. 875; Rent receivable Rs. 50; Provide 5 % for doubtful debts. Allow interest on capital at 5 % per annum. Provide depreciation 2 % of business premises.

Ans: *[Gross profit Rs. 2,281; Net profit Rs. 836; Balance Sheet total Rs. 18,647]*

5. X, Y and Z set up a partnership firm on 1.1.1994. They contributed Rs. 150000, Rs. 120000 and Rs. 90,000 respectively as their capitals and decided to share profit and loss in the ratio of 3 : 2 : 1. The partnership deed provided that A is to be paid a salary of Rs. 3000 per month and B a commission of Rs. 15000. It also provided that interest on capital be allowed at 6 % per annum. The drawings for the year were A Rs. 18000, B Rs. 12000 and C Rs. 6000. Interest on drawings was charged Rs. 810 on A's drawings Rs. 540 on B's drawings and Rs. 270 on C's drawings. The net amount of profit as per profit and loss account for the year 1994 was Rs. 106980.

You are required to prepare the Profit & Loss Appropriation Account and Partner's Capital Accounts after passing necessary journal entries.

Ans: *[Profit transferred to A Rs.18000, B Rs.12000 and C Rs. 6000]*

6. A, B and C are partners sharing profits and losses in the proportions of 3 : 2 : 1 with capitals of Rs. 10,000, Rs. 10,000 and Rs. 5,000 respectively. Each partner is entitled to 5 % interest on his capital. B and C are entitled to a salary of Rs. 150 and Rs. 100 per month respectively. During the year 1993, the drawings of the partners in anticipation of their shares of profit and salary are A – Rs. 1,000; B – Rs. 1,000 and C – Rs. 1,200. The profits for the year prior to calculation of interest on capital but after charging salary of partners amounted to Rs. 8,000. The above figure of profit is before charging depreciation at $7\frac{1}{2}$ per cent on furniture valued at Rs. 5,000 and writing off a bad debt of Rs. 150.

You are requested to prepare partners accounts (i) where capitals are fixed and (ii) where capitals are fluctuating.

Ans: *[Profit transferred to Partner's Capital/Current Account A Rs. 3112.50, B Rs. 2075, C Rs. 1037.50]*

ADMISSION OF PARTNER

7. X and Y are partners sharing profits and losses in the ratio of 3 : 1. Z is admitted into the partnership with a 1/4th share in the future profits which he takes entirely from A. Z brings in Rs. 40,000 on account of capital and Rs. 24000 on account of goodwill. Pass journal entries.

8. P & Q share profits and losses in the ratio of 5 : 3. They admit R into partnership. R brings in Rs. 100,000 as capital and Rs. 30,000 as goodwill. The new profit sharing ratio is 7 : 4 : 3. Make journal entries.

9. A and B are partners sharing profits in the ratio of 3 : 2. C is admitted as a partner and is to be given 1/6 of the profit. His share of goodwill is Rs. 40,000. Give journal entries if old partners do not withdraw the amount of goodwill and when they withdraw the amount of goodwill.

10. **Salman and Rehman carrying on business in partnership and sharing profits and losses in the ratio of 3 : 2 require a partner when their balance sheet stood as follows:**

Assets	*Rs.*	*Liabilities*	*Rs.*
Cash	1,500	Creditors	11,800
Stock	28,000	Salman's capital	51,450
Debtors	19,500	Rehman's capital	36,750
Furniture	2,500		
Machinery	48,500		
	1,00,000		1,00,000

They admit Imran into partnership and give him 1/8th share in future profits on the following terms:

(a) Goodwill of the entire firm be valued at twice the average of the last three year's profits which amounted to Rs. 21,000, Rs. 24,000 and Rs. 25,560.

(b) Imran to bring in cash for the amount of his share of goodwill.

(c) He is to bring in cash Rs. 15,000 as his capital.

Give journal entries recording these transactions and draw out the balance sheet of the new firm and state the future profit sharing ratio.

Ans: *B/S Total Rs.120,880. New Ratio = 21:14:5*

11. **Rameez and Raja are partners sharing profits in the ratio 3:2. Their balance sheet stood as under on 31-12-1991:**

BALANCE SHEET

Assets		*Rs.*	*Liabilities*		*Rs.*
Cash		2,000	Creditors		38,500
Stock		15,000	Outstanding liabilities		4,000
			Capitals		
Prepaid insurance		1,500	Ramzeez	29,000	
Debtors	9,400		Raja	15,000	44,000
Less Provision	400	9,000			
Machinery		19,000			
Buildings		35,000			
Furniture		5,000			
		86,500			86,500

Rahim is admitted as a new partner introducing a capital of Rs. 16,000. The new profit sharing ratio is decided as 5 : 3 : 2. Rahim is unable to bring in any cash for goodwill. So it is decided to raise goodwill account, amount being calculated on the basis of Rahim's share in the profits and the capital contributed by him. Following revaluations are made

(i) Stock to be depreciated 5 %.

(ii) Provision for doubtful debts is to be increased to Rs.500.

(iii) Furniture to be depreciated 10 %.

(iv) Building is valued at Rs. 40,000.

Show the necessary ledger accounts and the balance sheet of the new firm.

Ans: *Revaluation Profit Rs.3650: B/S Total Rs.126.150.*

12. Saleem, Kaleem and Rahim trading in partnership and sharing profits and losses in the proportion of 1/2, 1/3 and 1/6 respectively agree to take Asif into the partnership on the following terms:

(a) Asif should be given 1/4 share and he should bring Rs. 10,000 as goodwill and Rs. 1,28,000 as capital.

(b) A reserve for bad and doubtful debts should be created at 5 %.

(c) The value of Land and Building should be brought up to Rs. 6,20,000.

(d) Stock should be taken at Rs. 2,61,000.

(e) Machinery should be revalued at Rs. 61,600.

The following is the Balance Sheet of the firm of Saleem, Kaleem and Rahim on the date of Asif's admission.

BALANCE SHEET AS ON 31.12.1992

Assets	*Rs.*	*Liabilities*		*Rs.*
Cash in hand	8,000	Sundry creditors		38,000
Debtors	2,52,000	Partner's Capitals:		
Stock	2,90,000	Saleem	5,70,000	
Machinery	70,000	Kaleem	3,20,000	
Land and Building	4,80,000	Rahim	1,60,000	10,50,000
		Reserve fund		12,000
	11,00,000			11,00,000

Pass Journal entries in the books of the new firm, keeping these arrangements in view and show the necessary accounts and Balance Sheet of the newly–constituted firm.

Ans: *[Revaluation Profit Rs. 90,000: B/S Rs. 1328000]*

13. **The Balance Sheet of Mr. Shabir and Mr. Majid as on 31st December 1994 is set out below. They share profits and losses in the ratio of 2:1.**

Assets	*Rs.*	*Liabilities*	*Rs.*
Freehold Property	20,000	Shabir's Capital	40,000
Furniture	6,000	Majid's Capital	30,000
Stock	12,000	General Reserve	24,000
Debtors	60,000	Creditors	16,000
Cash	12,000		
	1,10,000		1,10,000

They agree to admit Pasha into the firm subject to the following terms and conditions:

(a) **Pasha will bring in Rs. 21,000 of which Rs. 9,000 will be treated as his share of Goodwill to be retained in the business.**

(b) **He will be entitled 1/4th share of the profits of the firm.**

(c) **Fifty per cent of the General Reserve is to remain as a Reserve for Bad and Doubtful Debts.**

(d) **Depreciation is to be provided on Furniture at 5 %.**

(e) **Stock is to be revalued at Rs. 10,500.**

Show the journal entries giving effect to the above said arrangements (including cash transaction) and prepare the Opening Balance Sheet of the new partnership.

Ans: *[Revaluation Loss Rs. 1800: B/S Rs. 117200]*

14. **A and B are partners in a firm sharing profits and losses as 5:3. The position of the firm as on 31st March 1994 is as follows:**

Assets	*Rs.*	*Liabilities*		*Rs.*
Plant & Machinery	40,000	Capital Accounts:		
Stock	30,000	A	30,000	
Sundry Debtors	20,000	B	20,000	50,000
Bills receivable	10,000	Sundry Creditors		15,000
Cash at Bank	7,500	Bank overdraft		42,500
	1,07,500			1,07,500

C now joins them on condition that he will share 3/4th of the future profits, the balance of profits being shared by A and B as 5:3. He introduces Rs. 40,000 by way of capital in cash and pays off the overdraft. He also pays Rs. 4,000 by way of premium for goodwill of the busines and this amount is to remain in business. The partners agree to depreciate plant by 10 % and raise a reserve against Sundry Debtors by 5 %.

You are asked to journalise the entries in the books of the firm and the resultant Balance Sheet and also show how will the partners share future profits.

Ans: *[Revaluation Loss Rs. 5000: B/S Rs. 146500]*

15. Zulfiqar and Fayyaz are partners in a firm sharing profits and losses as Zulfiqar 3/4 and Fayyaz 1/4 on 1st January, 1993, their position was as given below:

Assets	*Rs.*	*Liabilities*		*Rs.*
Plant	40,000	Capital Accounts:		
Stock	10,000	Zulfiqar	50,000	
Debtors	30,000	Fayyaz	30,000	80,000
Cash at Bank	20,000	Sundry Creditors		20,000
	1,00,000			1,00,000

Riaz is now to join the partnership. He agrees to pay the partners Rs. 20,000 by way of goodwill and introduce 3/5 of the combined capital of the two existing partners after depreciating plant and stock at 20 % and 10 % respectively and raising a reserve of 10 % against Sundry Debtors. The new partner is to be allowed 1/4th share of the profits of the firm.

You are asked to record the above transactions in the books of the firm and give the resultant Balance Sheet of the new firm.

Ans: *[Revaluation loss Rs. 12000: B/S Rs. 160800]*

16. Mukhtar and Munir were partners in a firm sharing profits equally. Their business position as on 30th June 1994 was as follows:

BALANCE SHEET

Assets	*Rs.*	*Liabilities*	*Rs.*
Cash in hand	150	Sundry Creditors	6,000
Stock	3,600	Bank overdraft	1,500
Sundry Debtors	6,200	Mukhtar's Capital	2,100
Furniture	600	Munir's Capital	1,600
Investments	650		
	11,200		11,200

It is agreed to take Mobeen into partnership and to make the following adjustments:

(a) Bad debts to be written off for Rs. 1,600.

(b) Value of the furniture to be reduced to Rs. 400.

(c) Depreciate stock at 10 %.

(d) Write off 20 % on investments.

(e) Raise goodwill for Rs. 1,000.

Mobeen introduced Rs. 1,000 as capital for his 1/3 share. Other partners' capitals should be adjusted according to the new partner's capital.

Pass necessary Journal entries and prepare the Balance Sheet of the new firm.

Ans: *[B/S Total Rs. 10500]*

17. Amir and Babar share profits in the proportion of three–fourth and one–fourth. The Balance Sheet on December 31, 1993 was as follows:

Assets	*Rs.*	*Liabilities*	*Rs.*
Cash at Bank	45,000	Sundry Creditors	83,000
Bills receivable	6,000	Amir's Capital	60,000
Debtors	32,000	Babar's Capital	32,000
Stock	40,000		
Fixtures	2,000		
Buildings	50,000		
	1,75,000		1,75,000

On January 1, 1994 Jamal was admitted into partnership on the following terms:

(a) That Jamal pays Rs. 20,000 as his capital for a fifth share.

(b) That Jamal pays Rs. 10,000 for Goodwill. Half of this sum is to be withdrawn by Amir and Babar.

(c) That the capitals of Amir and Babar be adjusted on the basis of Jamal's capital.

(d) That Stock and Fixtures be reduced by 10 % and a 5 % provision be created for doubtful debts on Debtors and Bills receivable.

(e) That value of Buildings be appreciated by 20 %.

(f) That an item of Rs. 650 included in creditors is not likely to be claimed and hence should be written back.

Prepare Revaluation Account, Capital Accounts and give Balance Sheet of the new firm.

Ans: *[Profit on revaluation Rs. 4550: B/S Rs. 182350]*

18. A and B sharing profits in the proportion of three fifths and two–fifths showed the following as their balance sheet on 31st December, 1994.

Assets	*Rs.*	*Liabilities*		*Rs.*
Cash at bank	5,000	Creditors		52,000
Land and building	25,000	Reserve fund		10,000
Plant and machinery	35,000	Capital accounts:		
Furniture and fixtures	1,500	A	35,000	
Stock	20,500	B	35,000	70,000
Debtors	45,000			
	1,32,000			1,32,000

They take C into partnership on 1st Jnuary, 1995, the terms being that he shall pay Rs. 5,000 as his share of the Goodwill, the amount to be retained in the business and that he shall bring in Rs. 15,000 as capital for a fourth share in the future profits. For the purpose of C's admission, the firms assets were agreed to be revalued as under.

Land and building to be taken at Rs. 30,000, plant and fixtures to be reduced by 10 per cent and a provision of 5 % on debtors is to be made for doubtful debts. The stock is to be taken at a value of Rs. 25,000.

Set out the necessary journal entries, the revaluation account, the capital accounts of the partners and the opening balance sheet of the new firm.

Ans: *Revaluation Profit Rs. 3600 :. B/S Total Rs.1,55,600.*

19. Balance Sheet as on 31.12.1993 of Akif, Asim and Nadir who were sharing profits and losses in the ratio of 2 : 3 : 5.

	Rs.		Rs.
Cash	18,000	Capitals	
Bills receivable	24,000	Akif	36,000
Furniture	28,000	Asim	44,000
Stock	44,000	Nadir	52,000
Debtors	42,000	Creditors	64,000
Investments	32,000	Bills payable	32,000
Machinery	34,000	Profits and loss account	14,000
Goodwill	20,000		
	2,42,000		2,42,000

They admit Ahsan into partnership on the following terms:

1. Furniture, investments and machinery to be reduced by 15 %.
2. The value of stock to be taken at Rs. 48,000.
3. Goodwill to be valued at Rs. 26,000.
4. Ahsan to bring Rs. 32,000 towards capital for $\frac{1}{6}$ share and old partners to adjust their capitals accordingly.
5. Outstanding rent amounted to Rs. 1,800.
6. Prepaid salaries Rs. 800.
7. Adjustment of capitals to be made by cash.

Prepare revaluation account, capital accounts of old partner, cash account and balance sheet of the new firm.

Ans: *Revaluation Loss Rs.11,100 : B/S Total Rs.2,89,800.*

20. The following was the Balance Sheet of P and Q on 31st December 1993. They share profits and losses in the ratio of 5:3.

Assets	*Rs.*	*Liabilities*	*Rs.*
Furniture	1,500	Creditors	8,000
Debtors	10,000	General Reserve	4,000
Stock	15,000	P's Capital	10,000
Cash	500	Q's Capital	5,000
	27,000		27,000

They admit R into partnership giving him 1/8th share on the following terms:

(a) Furniture to be depreciated by 5 %.

(b) Reserve for doubtful debts on Debtors at 5 %.

(c) Stock to be appreciated by 10 %.

(d) Goodwill Account is to be raised at two years' average profits of last three years which amounted to Rs. 2,000, Rs. 2,500 and Rs. 3,000. The capital of the old partners are to be adjusted in proportion of the profit sharing ratios.

(e) R brings in cash towards his capital, to the extent of 1/6th of the combined capitals of the old partners after all the above adjustments.

Pass necessary Journal and Ledger entries and prepare the Balance Sheet of the new firm.

Ans: *[Revaluation Profit Rs. 925, B/S Rs. 37079]*

21. **Roshan and Shahzad are partners in a firm sharing profits in the ratio of 3:2 on 1st January 1994, the position of the business was as follows:**

BALANCE SHEET

Assets	*Rs.*	*Liabilities*		*Rs.*
Goodwill	5,000	Sundry Creditors		15,000
Stock	20,000	Capital Accounts:		
Plant	25,000	Roshan	30,000	
Debtors	18,000	Shahzad	25,000	55,000
Cash	2.000			
	70,000			70,000

Sabir agrees to join the business on the following conditions:

(a) **He will introduce Rs. 20,000 as his capital and pay Rs. 10,000 to the partners as premium for goodwill for 1/4th share of the future profits of the firm.**

(b) **Revaluation of the assets of the firm will be made by reducing plant account to Rs. 20,000 and stock by 10 % and by raising a provision for bad debts at 5 % of debtors.**

You are asked to give the necessary entries in the books of account, recording the above transactions and give the balance sheet of the new firm. Goodwill is to appear at its old figure in the new Balance Sheet.

Ans: *[Revaluation Loss Rs. 7900, B/s Rs. 82100]*

22. **The following is the Balance Sheet of Jamil and Jalil as on 31st March 1994. Naseem is admitted as partner on that date when the position of business was as under:**

Assets	*Rs.*	*Liabilities*	*Rs.*
Debtors	3,300	Jamil's Capital	3,000
Land and Building	2,400	Jalil's Capital	2,400
Plant and Machinery	3,000	Creditors	3,600
Stock	3,600	General Reserve	4,800
Cash and Bank Balances	2,700	Workmen's compensation fund	1,200
	15,000		15,000

Jamil and Jalil shared profits in the proportion of 3:2. The following terms of admission are agreed upon:

(1) **Revaluation of assets: Land and Building Rs. 5,400, stock Rs. 4,800.**

(2) **The liability on workmen's compensation fund is determined at Rs. 600.**

(3) **The new partner has to bring in as his share of goodwill Rs. 3,000 in cash.**

(4) The new partner was to bring further cash as would make his capital equal to 20 % of the combined capitals of partners Jamil and Jalil after above revaluation and adjustments are carried out.

(5) The future profit sharing proportions were as under: Jamil – 2/5th; Jalil – 2/5th; Naseem – 1/5th. Prepare the new Balance Sheet of the firm and the capital accounts of the partners.

Ans: *[Revaluation Profit Rs. 4200, B/s Rs. 25800].*

23. On 1st January, 1991, A and B who were in partnership sharing 7/12 and 5/12 respectively, take in C giving him 1/6 share. A and B were to share future profits in the ratio of 13/24 and 7/24.

Over and above his capital, C brought in Rs. 96,000 as his goodwill for the 1/6 share. The cash brought in by C as his capital and his goodwill is credited to one separate account in his personal name. On 31st December, 1991 the Trial Balance of the firm stood as follows:

	Rs.		*Rs.*
Machinery	6,00,000	A's Capital	3,36,000
Furniture	40,000	B's Capital	2,40,000
Stock	1,20,000	C's Capital	2,24,000
Debtors	2,00,000	Creditors	48,000
A's drawings	32,000	Current year's profit	2,32,000
B's drawings	52,000		
C's drawings	8,000		
Cash in hand	28,000		
	10,80,000		10,80,000

Interest on drawings is to be ignored but interest on capital accounts is to be allowed at 5 % per annum after the necessary adjustments therein consequent to C's admission. Prepare the Balance Sheet of the firm as on December 31, 1991.

NOTE:

1. Interest on Capital to be allowed on the amount which is remained after adjusting the goodwill into the Capital Accounts.
2. The sacrificing ratio is to be taken into account, when the goodwill is brought in by new partner in cash; and also when the old ratio and new ratio is given.

Ans: *[B/s Total Rs. 988000: Capitals: A: Rs. 450,000, B: Rs. 331600, C: Rs. 158400]*

24. **Saima and Uzma are partners in a firm sharing profits in the ratio of 2:1. The Balance Sheet of the firm on 31st December 1994 was as follows:**

Assets		*Rs.*	*Liabilities*		*Rs.*
Bank		**3,012**	**Creditors**		**4,200**
Bills receivable		**7,500**	**Investments provision**		**1,200**
Debtors	**12,000**		**Workmen compensation fund**	**3,600**	
Less: Provision	**1,500**	**10,500**	**General Reserve**		**6,300**
Stock		**9,000**	**Capitals:**		
Investments		**15,000**	**Saima**	**18,000**	
Goodwill		**2,988**	**Uzma**	**14,700**	**32,700**
		48,000			**48,000**

On the above date Mehnaz is admitted for 2/5th share in the profits of the firm. Following revaluations were made at the time of admission:

(1) **Accrued incomes not appearing in the books Rs. 300.**

(2) **Market value of investments is Rs. 13,500.**

(3) **Claim on account of compensation is estimated at Rs. 450.**

(4) **Provision for doubtful debts is required at Rs. 1,800.**

(5) **X, an old customer, whose account was written off as bad, has promised to pay Rs. 1,050 in settlement of his full claim.**

(6) **Saima and Uzma had purchased a machinery on hire–purchase system for Rs. 9,000 of which only Rs. 300 are to be paid. Both machinery and unpaid liability did not appear in the Balance Sheet.**

(7) **There was a Joint Life Policy on the lives of Saima and Uzma for Rs. 45,000. Surrender value of the policy on the date of admission amounted to Rs. 7,200. It was decided to record this as an asset of the new firm.**

(8) **Mehnaz is required to bring in Rs. 30,000 as capital. Her share of Goodwill was calculated at Rs. 7,200.**

You are required to make Journal entries and prepare new Balance Sheet after the admission of Mehnaz.

Ans: *[Revaluation Profit Rs. 19800, B/s Rs. 110262]*

RETIREMENT:

Calculation of New and Gaining Ratio:

25. **A, B and C were sharing profits as 1/2 to A, 1/5 to B and 3/10 to C. C retires. Calculate new profit sharing ratio of A and B.**

Ans: *[5 : 2]*

26. **Calculate new profit sharing ratio:**

A, B, C and D were partners sharing profits in the ratio of 5 : 4 : 3 : 2. A and C retire from the firm.

Ans: *[4 : 2]*

27. **Calculate new profit sharing ratio:**

A, B and C are partners in a firm sharing profits & losses in the ratio of 5 : 3 : 2. B retires. His share was taken up by A and C in the ratio of 2 : 1.

Ans: *[7 : 3]*

28. **Calculate new and gaining ratio:**

A, B and C were partners sharing profits in the ratio of 3 : 2 : 1.

(a) When A retires (b) When B retires (c) When C retires.

Ans: *[New gaining ratio]*

(a)	*2 : 1*	*2 : 1*
(b)	*3 : 1*	*3 : 1*
(c)	*3 : 2*	*3 : 2*

29. **A and B are equal partners in a firm. Partnership deed provides that any partner may retire from the firm, on the following terms, after giving three months' notice in writing:**

Retiring partner shall be paid:

(i) Balance of his capital and current accounts.

(ii) Share of profit to the date of retirement calculated on the basis of the average profit of the three preceding years.

(iii) Share of goodwill of the firm calculated at twice the average profits of the three preceding completed years.

B gave a notice on June 30, 1993 to retire and retired on September 30, 1993 when his capital account showed a credit balance of Rs. 20,000 and current account debit balance of Rs. 3,000. Profits for the three preceding years were Rs. 28,000, Rs. 22,000 and Rs. 16,000. Firm's year ends on March 31st every year.

Calculate the amount due to B.

Ans: *[Amount due to B Rs. 44,500]*

30. A, B and C are partners, sharing profits equally. Their Balance Sheet at 31st December 1993 is as follows:

Assets		*Rs.*	*Liabilities*	*Rs.*
Cash at Bank		4,000	Sundry Creditors	4,000
Bills receivable		3,000	Capitals:	
Sundry debtors	20,000		A	12,000
Less: Reserve for			B	18,000
bad debts	1,000	19,000	C	7,500
Stock		18,000	Reserve	6,000
Fixtures		3,500		
		47,500		47,500

B retires on that date and the following adjustments are to be made for the purpose:

(a) Goodwill of the firm is valued at Rs. 12,000.

(b) Fixtures to be depreciated by 5 %.

(c) Stock to be appreciated by 10 %.

(d) Reserve for bad debts to be increased by Rs. 500.

Draw up the Revaluation Account, Capital Accounts of the partners and the Opening Balance Sheet of the continuing partners.

Ans: *[Realisation Profit Rs. 1125, Amount Payable to B. Rs. 24375, B/s Rs. 60625].*

31. A, B and C were carrying on business in partnership sharing profits and losses in ratio 3:2:1. On 31st December 1993, Balance Sheet of the firm stood as follows:

Assets	*Rs.*	*Liabilities*		*Rs.*
Cash	5,900	Sundry Creditors		13,590
Debtors	8,000	Capital Accounts:		
Stock	11,690	A	15,000	
Buildings	23,000	B	10,000	
		C	10,000	35,000
	48,590			48,590

B retired on the above mentioned date on the following terms:

(i) **Buildings be appreciated by Rs. 7,000.**

(ii) **Provision for bad debts be made @ 5 % on debtors.**

(iii) **Goodwill of the firm be valued at Rs. 9,000 and adjustment in this respect be made without raising Goodwill Account.**

(iv) **Rs. 5,000 be paid to B immediately and the balance due to him be treated as a loan carrying interest @ 6 % per annum. Pass Journal entries to record the above transactions and show the Balance Sheet of the firm as it would appear immediately after B's retirement.**

Ans: *[Revaluation gain Rs. 6600, Amount transferred to B's Loan A/c Rs. 10200, B/s Rs. 50190].*

32. **Amjad, Anwar and Arif were partners sharing profits and losses in the ratio 3:2:1. Their Balance Sheet on 31st December 1994 was as follows:**

Assets	*Rs.*	*Liabilities*		*Rs.*
Cash at Bank	3,500	Sundry Creditors		15,000
Bills receivable	2,000	Bills payable		5,000
Investments	6,500	Capitals:		
Debtors	6,000	Amjad	10,000	
Stock	5,000	Anwar	10,000	
Furniture	2,000	Arif	10,000	30,000
Buildings	25,000			
	50,000			50,000

Arif retired on the above date and the partners agreed that:

(a) **Goodwill should be calculated on the basis of two years' profits of the average of the preceding three years' profits. The profits for the years 1991, 1992 and 1993 were Rs. 16,000, Rs. 12,000 and Rs. 14,000 respectively.**

(b) **Rs. 510 to be provided for doubtful debts.**

(c) **Stock to be reduced by 10 %.**

(d) **There was an appreciation in the value of buildings by 5 %.**

Show the Revaluation Account and the Balance Sheet of the continuing partners.

Ans: *[Profit on revaluation Rs. 240, B/s Rs. 78240, Amount Payable to Arif Rs. 14707]*

33. P, Q and R are partners, sharing profits equally. Balance Sheet at 31st December, 1993 is as follows:

Assets		*Rs.*	*Liabilities*	*Rs.*
Cash at Bank		3,000	Sundry Creditors	5,000
R's current a/c		2,500	Current Accounts:	
Bills receivable		5,000	P	2,000
Sundry debtors	20,000		Q	3,000
Less: Bad debts			Reserve	6,000
provision	1,000	19,000	Capitals:	
Stock		18,000	P	10,000
Fixtures		3,500	Q	15,000
			R	10,000
		51,000		51,000

R retires on that date and the following adjustments are to be made for the purpose:

(1) Goodwill is valued at Rs. 12,000.

(2) Fixtures to be depreciated by 5 %.

(3) Stock to be appreciated by 10 %.

(4) Bad debts provision to be increased by Rs. 500.

Find out the amount due to R and transfer it to his loan account. Pass Journal entries, open partners accunt and Revaluation account, and prepare the opening Balance Sheet of the continuing partners.

Ans: *[Amount due to R Rs. 13875, Revaluation Profit Rs. 1125, B/s Rs. 61625]*

34. Galib, Bashir and Saleem are in partnership sharing profits and losses in the ratio of 2:2:1. Saleem retires on 31st December, 1994. The Balance Sheet of the firm on the date of retirement of Saleem is as follows:

Balance Sheet of the firm as at 31st December, 1994

Assets	*Rs.*	*Liabilities*		*Rs.*
Cash in hand	500	Creditors		2,300
Cash at Bank	3,000	General Reserve		2,500
Debtors	6,000	Capitals:		
Stock	10,000	Galib	10,000	
Buildings	8,000	Bashir	8,000	
Furniture	2,000	Saleem	7,200	25,200
Goodwill	1,000	Profit & Loss a/c		500
	30,500			30,500

The following adjustments are to be made:

(1) **Buildings is to be revalued at Rs. 10,000.**

(2) **Bad debts to be written off Rs. 400.**

(3) **Stock is to be revalued at Rs. 9,000.**

(4) **Furniture is to be revalued at Rs. 1,800.**

(5) **The Goodwill of the firm is to be completely written off.**

(6) **It was agreed to pay Rs. 2,000 only to the sundry creditors in full settlement of their dues.**

(7) **The amount available at Bank is agreed to be paid to Saleem and the balance of the amount due to Saleeem to be transferred to his loan account.**

You are required to prepare Capital accounts of the partners, Revaluation account and Balance Sheet of the firm.

Ans: *[Revaluation Loss Rs. 300, Amount due to Saleem Rs. 4740, B/s Rs. 26900]*

DEATH:

35. X and Y are in partnership sharing profits and losses in the ratio of 3:2. They insure their lives jointly for Rs. 75,000 at an annual premium of Rs. 3,500 to be debited to the business. Y dies three months after the date of the last Balance Sheet. According to the partnership deed, Y's legal representatives are entitled to the following payments:

(a) **His capital as per the last Balance Sheet.**

(b) **Interest on above capital at 6 % per annum to date of death.**

(c) **His share of profit to date of death calculated on the basis of last year's profit.**

(d) **His share of insurance money.**

His drawings are to bear interest at an average rate of 2 % on the amount irrespective of period.

Y's Capital as per the last Balance Sheet was Rs. 40,000 and his drawing to date of death were Rs. 5,000. The last year's profit was Rs. 30,000.

Draw Y's account to be rendered to his legal representatives.

Ans: *[Amount Payable to Executors of Y Rs. 68500]*

36. A, B and C are partners sharing profits and losses in the proportion of 3:2:1 and their Balance Sheet on 31st December, 1994 was as follows:

Assets	*Rs.*	*Liabilities*		*Rs.*
Cash in hand	250	Bills payable		7,560
Cash at Bank	960	Creditors		12,300
Bills receivable	3,300	General Reserve		3,000
Debtors	7,450	Capitals:		
Stock	12,470	A	10,000	
Investments	10,430	B	6,000	
Building	8,000	C	4,000	20,000
	42,860			42,860

B died on February 28, 1995 and according to partnership agreement his executor is entitled to be paid out as follows:

(a) The capital to his credit at the time of his death and interest up to the time of his death at 6% per annum.

(b) His appropriate share of general reserve.

(c) His share of profit to the date of his death which is to be taken on the basis of preceding year's profit.

(d) His share of Goodwill which is calculated at two year's purchase of the average profit of the preceding three years.

The Investments were sold for Rs. 16,020 and B's executor was paid off. The profits in the three preceding years were 1992 – Rs. 7,800; 1993 – Rs. 9,000; 1994 – Rs. 9,600.

Pass the Journal entries and write the account of B.

Ans: *[Amount paid to B's executor Rs. 13460]*

37. P, Q and R were partners sharing profits and losses in the ratio of 3:2:1. On 31st December, 1994 their Balance Sheet was as follows:

Assets	*Rs.*	*Liabilities*		*Rs.*
Goodwill	6,000	Creditors		8,000
Buildings	20,000	General Reserve		9,000
Patents	5,000	P	35,000	
Machinery	15,000	Q	20,000	
Stock	8,000	R	15,000	70,000
Debtors	8,000			
Cash at Bank	25,000			
	87,000			87,000

Q died on 1st July 1994. The following terms and conditions were agreed upon between his executors and the remaining partners.

(a) Goodwill was valued at $1\frac{1}{2}$ years purchase price of past three years' profits which were as follows:

	Rs.
1991	16,000
1992	8,000
1993	12,000

(b) Patents were valued at Rs. 8,000; buildings at Rs. 25,000; and machinery at Rs. 24,000.

(c) Profit up to the date of death of Q was to be taken on the basis of the average profits of the past three years.

(d) Interest on capital at 5 % per annum was to be charged.

(e) Cash amounting to Rs. 7,500 was paid immediately and the balance due to the executors of the deceased was payable together with interest at 6 % per annum in two equal yearly instalments.

(f) Reserve for bad and doubtful debts was to be provided for an amount of Rs. 1,000.

(g) Q's Drawings up to the date of his death were Rs. 4,000.

Draft the necessary Journal entries to record the above transactions and prepare Q's Capital Account as on the date of his death.

Ans: *[Amount payable to Q's executor Rs. 23333]*

38. A and B who shared profits in the ratio of 3:2 took out a Joint Life Policy on 1st May, 1990, for Rs. 30,000. The annual premium was Rs. 1,300. The surrender value of the policy was:

1990 – nil, 1991 – Rs. 400; 1992 – Rs. 900; 1993 – Rs. 1,450.

B died on 15th September, 1993 and the amount of the Policy was received on 31st December, 1993. The books are closed on December 31 each year.

Give Journal entries if premium paid is written off to Profit and Loss Account each year.

DISSOLUTION:

39. The Balance Sheet of a firm showed the following position as on 31st December 1992.

Assets	*Rs.*	*Liabilities*		*Rs.*
Buildings	40,000	Partners Capital		
Investments	10,000	Accounts:		
Debtors	5,000	D	25,000	
Bank Balance	15,000	E	20,000	
		F	15,000	60,000
		Sundry creditors		10,000
	70,000			70,000

The partnership was dissolved on 31.12.1992. Creditors were paid at 5 % discount. D agreed to take over buildings at Rs. 45,000, E took over investments at Rs. 26,000 and F took over debtors at Rs. 3,000.

Prepare realisation account and close the books of the firm.

Ans: *[Profit on realisation Rs. 19500]*

40. The following was Balance Sheet of Rashid and Akbar as on 31st December 1994.

Assets		*Rs.*	*Liabilities*	*Rs.*
Cash at Bank		11,500	Sundry Creditors	38,000
Stock-in-Trade		6,000	Mrs. Rashid's Loan	10,000
Sundry Debtors	20,000		Akbar's Loan	15,000
Less: Provisions	1,000	19,000	Reserve Fund	5,000
Furniture & Fittings		4,000	Rashid's Capital	10,000
Machinery and Plant		28,000	Akbar's Capital	8,000
Investments		10,000		
Profit and Loss accounts		7,500		
		86,000		86,000

The firm was dissolved on 31st December, 1994 and the following was the result:

(a) Rashid took over investments at an agreed value of Rs. 8,000 and agreed to pay of the loan of his wife.

(b) The assets realised the following:

	Rs.
Stock	5,000
Debtors	18,000
Furniture & Fittings	4,500
Machinery and Plant	25,5000

The Expenses of dissolution were Rs. 1,100

(c) The Sundry creditors were paid off less $2\frac{1}{2}$ % discount. Rashid and Akbar shared profits and losses in the ratio of 3 : 2. Journalise the entries to be made on the dissolution and show Realisation Accounts, Cash Account and Partners' Capital Accounts.

Ans: *[Realisation Loss Rs. 6150, Amount Received: Rashid Rs. 6810: Akbar Rs. 4540]*

41. The following was the Balance Sheet of Waqas and Rehman as on 31st December 1994. On that date they want to dissolve the firm.

Assets	*Rs.*	*Liabilities*		*Rs.*
Furniture	400	Reserve		2,000
Stock	7,200	Sundry Creditors		3,800
Debtors	12,000	Capital:		
Machinery	1,800	Waqas	11,000	
Profit & Loss a/c	3,400	Rehman	8,000	19,000
	24,800			24,800

Debtors realised with a $7\frac{1}{2}$ % expenditure. Stock, machinery and furniture were sold for Rs. 6,000, Rs. 1,400 and Rs. 500 respectively. Basing on the above balance sheet prepare the necessary ledger accounts. Partners share profits equally.

Ans: *[Realisation Loss Rs. 2400, Amount Received by Waqas Rs. 9100, Rehman Rs. 6100]*

42. A, B and C carrying on business as merchants and sharing profits and losses in the ratio of 2 : 2 : 1, dissolved their firm as on December, 31, 1994 on which date their Balance Sheet was as follows:

Assets		*Rs.*	*Liabilities*		*Rs.*
Cash at Bank		13,500	Sundry creditors		60,900
Stock		48,000	Reserve fund		30,000
Debtors	30,000		Joint Life Policy Reserve		24,000
Less: Provision	1,500	28,500	Capital Accounts:		
Joint Life Policy		33,000	A	45,000	
Premises		90,900	B	45,000	
			C	9,000	99,000
		2,13,900			2,13,900

There is a bill for Rs. 3,000 under discount. The bill was received from D.

The assets except cash at Bank and Joint Life Policy were sold to a company which paid Rs. 1,95,000 in cash. The Joint Life Policy was surrendered and Rs. 33,900 was received. D proved insolvent and a dividend of 50 % was received from his estate. Sundry creditors were paid Rs. 58,500 in full settlement. The expenses amounted to Rs. 9,000.

Prepare the Realisation Account, Cash Account and partners' Accounts.

Ans: *[Realisation profit Rs. 44400, Cash Received by A Rs. 74760, B Rs. 74760, C Rs. 23880]*

43. Mr. Saeed and Mr. Ijaz are partners sharing profits as 2 : 1. The position of the firm as on 31st December 1992 when they decided to dissolve the business was as follows:

Assets	*Rs.*	*Liabilities*		*Rs.*
Plant & Machinery	25,000	Sundry Creditors		15,000
Furniture	4,000	General Reserve		10,000
Stock	10,000	Capital Accounts:		
Sundry Debtors	20,000	Mr. Saeed	22,000	
Cash at Bank	10,000	Mr. Ijaz	22,000	44,000
	69,000			69,000

The realisation shows the following result:

(a) Mr. Saeed took over plant and machinery and furniture at Book values less 10 per cent.

(b) Mr. Ijaz took over the stock and goodwill at Rs. 17,500.

(c) Sundry debtors realised Rs. 18,500.

(d) Sundry creditors were settled at a discount of 5 per cent.

Close the books of the firm.

Ans: *[Realisation profit Rs. 3850, Cash Received by Mr. Saeed Rs. 5134, Ijaz Rs. 9116]*

44. Rashid and Mohsin were in partnership sharing profits in the ratio 3 : 1. They agreed to dissolve the firm. The assets realized Rs. 1,50,000. The liabilities and other particulars of the firm on the date of dissolution were as follows:

		Rs.
Creditors		**90,000**
Loan from	**— Rashid**	**40,000**
Capital	**— Rashid**	**20,000**
	— Mohsin	**30,000**
Realisation expenses		**2,000**
Creditors were settled by payment of		**88,000**

Prepare necessary accounts showing final settlement.

Ans: *Realisation Loss Rs.30,000 : Cash Received by Rashid Rs.2500, cash paid to Mohsin Rs.22500.*

45. A, B and C carrying on business and sharing profits in the ratio of 3:2:1 respectively agreed to dissolve their partnership firm on 31st December 1993. The Balance Sheet of the firm as on that date is as follows:

Assets	*Rs.*	*Liabilities*	*Rs.*
Machinery	**1,00,000**	**Creditors**	**88,000**
Stock	**60,000**	**Capital accounts:**	
Debtors	**78,000**	**A**	**1,00,000**
Cash at bank	**32,000**	**B**	**10,000**
		C	**72,000**
	2,70,000		**2,70,000**

A agreed to take over machinery at on agreed value of Rs. 80,000. A sum of Rs.63,000 could be realised from debtors and stock was sold for Rs. 46,000.

The creditors were satisfied by payment of Rs. 84,000. A agreed to bear all expenses of dissolution. For this service A is to be paid Rs. 3,000. Actual expenses amount to Rs. 5,000. Draw up a realisation account, bank account and partners capital accounts assuming that all partners are solvent.

Ans: *Realisation Loss Rs.48000 : Cash Received by A Rs.1000, B Rs. 6000 ; Cash paid to C Rs.64000*

46. A, B and C commenced business on 1st January 1994, with capitals of Rs. 50,000, Rs. 40,000 and Rs. 30,000 respectively. Profits and losses were shared in the ratio of 4 : 3 : 3. Capitals carried interest at 5 % per annum. During 1994 and 1995, they made profits of Rs. 20,000, and Rs. 25,000 (before allowing interest). Drawings of each partner were Rs. 5,000 per year.

On 31st December 1995, the firm was dissolved. Creditors on that date were Rs. 12,000. The assets realised Rs. 1,30,000 net. Give necessary accounts to close the Books of the firm.

Ans: *[Realisation Loss Rs. 17000, Cash Received by A Rs. 51455, B Rs. 38785, C Rs. 27760]*

47. Sun and Moon sharing profit and losses as to 4 : 3 respectively decide to wind up the partnership business on 31st December 1991 on which date Sun's capital was Rs. 12,000, Moon's capital was Rs. 300. As per the books there were sundry creditors outstanding to the extent of Rs. 3,000 and there was a cash balance of Rs. 300. Expenses of winding up came to Rs. 250. Sundry assets realised Rs. 13,150.

Close the book of the firm.

Ans: *[Realisation Loss Rs. 2100, Cash Received by Sun Rs. 10800, Cash paid by Moon Rs. 600]*

48. Red, Green and Blue sharing profits in the proportion of 3:2:1 agreed upon dissolution of their partnership on 31st December, 1994 on which date their Balance Sheet was as under:

Assets		*Rs.*	*Liabilities*		*Rs.*
Machinery		60,750	Capital Accounts:		
Stock–in–trade		11,325	Red	60,000	
Investments		31,245	Green	30,000	90,000
Joint Life Policy		21,000	Mrs. Red's Loan		15,000
Debtors	13,950		Creditors		27,750
Less: Provision	900	13,050	Life Policy Fund		21,000
Capital Account Blue		17,250	Investments fluctuation fund9,000		
Cash at Bank		8,130			
		1,62,750			1,62,750

The Life Policy is surrendered for Rs. 18,000. The investments are taken over by Red for Rs. 26,250. Red agrees to discharge his wife's loan. Green takes over all the stock at Rs. 10,500 and debtors amounting to Rs. 7,500 at 6,000. Machinery is sold for Rs. 82,500. The remaining debtors realise 50 % of book value. The expenses of realisation amount to Rs. 900.

It is found that an investment not recorded in the books is worth Rs. 4500. The same is taken over by one of the creditors at this value.

Show the necessary ledger accounts including the final accounts of the partners on completion of the dissolution of the firm.

Ans: *[Realisation Profit Rs. 42705, Cash paid to Red Rs. 70103, Green Rs. 27735, Cash brought by Blue Rs. 10133]*

49. **X, Y and Z are partners sharing profit and losses in the proportion of 5:3:2. They decide to dissolve the partnership firm on 1.1.1994 when the Balance Sheet is as noted below:**

Assets	*Rs.*	*Liabilities*		*Rs.*
Cash Balance	18,000	Sundry Creditors		1,82,000
Sundry Debtors	1,52,000	Capital accounts:		
Stock-in-trade	60,000	X	3,30,000	
Furniture & Fixtures	10,000	Y	1,30,000	4,60,000
Plant & Machinery	2,90,000			
Land and Buildings	80,000			
Z's Capital Account	32,000			
	42,000			6,42,000

The assets realised: Land and Buildings Rs. 1,00,000, Plant & Machinery Rs. 2,50,000; Sundry Debtors Rs. 1,21,000; Stock Rs. 47,000; Furniture & Fixtures Rs. 9,200. Expenses of Dissolution Rs. 3,600. Draw up Realisation Account and partners' Capital Accounts.

Ans: *[Realisation Loss Rs. 68400, Cash Received by X Rs. 295800, Y Rs. 109480, Cash brought by Z Rs. 45680]*

50. **P, Q and R are partners sharing profits as 2 : 2 : 1. They dissolved the partnership and Q continued the business by taking over the Goodwill of the business at Rs. 5,000. Their Balance Sheet is as follows:**

Assets	*Rs.*	*Liabilities*		*Rs.*
Cash in hand	700	Sundry Creditors		4,200
Cash at Bank	3,000	Bills payable		2,800
Bills receivable	4,500	Capitals:		
Book debts	9,800	P	17,000	
Investments	6,300	Q	20,000	
Office Motor Car	6,500	R	9,600	46,600
Stock	12,300			
Machinery	7,500			
Goodwill	3,000			
	53,600			53,600

P takes over investments at a value of Rs. 5,500 and the office car for Rs. 7,000. The other assets and liabilities are taken over by Q on revaluation agreed upon by all the partners as follows: Stock at Rs. 10,500 and Machinery at Rs. 8,200. The Bills Receivable and Book debts are taken over by him at their book values on P and R agreeing to keep with him an amount of Rs. 500 each as guarantee to cover any loss that he may sustain on realising these assets. P and R are paid out on Q's bringing in the necessary cash.

Show the necessary ledger accounts to close the books of the firm and prepare the Balance Sheet of Q.

Ans: *[Realisation Profit Rs. 600, Cash Received by P Rs. 4240, R Rs. 9220, Cash brought by Q Rs. 9760, B/S of Q. Rs. 38000]*

51. The Balance Sheet of A, B and C showed as under, when they decided to dissolve their business:

Assets	*Rs.*	*Liabilities*	*Rs.*
Cash at Bank	500	Creditors	7,000
Debtors	4,500	A's Capital	12,000
Stock	16,000	B's Capital	9,000
Machinery	10,000	C's Capital	3,000
	31,000		31,000

Debtors, Stock and Machinery realise 50 % of the book value and expenses of realisation come to Rs. 50. C is insolvent and is unable to bring in anything in respect of his debt to the firm. Show that final adjustment of accounts, (a) ignoring the decision in Garner v. Murray, and (b) in accordance with the decision of Garner v. Murray.

Ans: *[Loss on Realisation: Rs. 15300:*
(a)Loss on insolvency of C borne by A Rs. 1050 B Rs. 1050
(b)Loss on insolvency of C borne by A Rs. 1200 B Rs. 900]

If payment to cr is not mentioned then you must considere that the payment is made.

52. The position of Zahid, Shahid and Khalid on June 30, 1994 was as follows:

Assets	*Rs.*	*Liabilities*	*Rs.*
Cash	10,000	Sundry Creditors	25,200
Sundry Assets	68,000	Zahid Loan Account	16,000
Khalid Capital	31,200	Zahid Capital	25,600
		Shahid Capital	14,400
		Profit and Loss a/c	28,000
	1,09,200		1,09,200

Profits and losses are shared – Zahid 18/35; Shahid 7/35; Khalid 10/35. The firm is dissolved on the above date. Sundry assets realise Rs. 56,000. Sundry creditors are paid Rs. 24,000 in full settlement. Expenses amount to Rs. 3,200 Khalid is insolvent.

Assume the capitals are not fixed. Close the books of the firm.

Ans: *[Realisation Loss Rs. 14000, Khalid's deficiency Rs. 27200]*

53. **A, B and C are partners sharing profits and losses in the proportions of one–half, one–third and one–sixth respectively. The firms Balance Sheet as on 31st December 1994 was as follows:**

Assets	*Rs.*	*Liabilities*	*Rs.*
Cash at bank	14,000	Creditors	31,500
Debtors	32,600	Loan on mortgage	4,500
Stock	22,400	A's capital	30,000
Fixed assets	15,000	B's capital	20,000
C's capital overdrawn	2,000		
	86,000		86,000

It was resolved to dissolve the partnership as on this date. The fixed assets and stock realised Rs. 35,000. Bad debts and discounts allowed amounted to Rs. 1,600. The mortgage loan was paid off. The creditors were paid less discount of 5 %.

There was a claim for damages pending against the firm which was settled at Rs. 5,600. The expenses of realisation amounted to Rs. 375.

After realisation of assets C was adjudicated an as insolvent and a dividend of 25 paise in the rupee was received, in respect of the firm's claim against his estate.

You are required to close the books of the firm in accordance with the decision in Garner vs. Murray.

Ans: *Realisation Loss Rs.8400 : C's Deficiency Rs.2,550.*

54. **A, B and C were partners in a firm. They shared profits and losses: A 40 % B 30 % and C 30 %. The firm was dissolved and B was appointed to realise assets and distribute the proceeds. B is to receive 5 % commission on the amounts realised from sale of assets and to bear all expenses of realisation.**

The Balance Sheet on the date of dissolution was as under:

Assets		*Rs.*	*Liabilities*	*Rs.*
Cash		450	Creditors	17,700
Debtors	13,650		A's Capital	9,000
Less: Provision	750	12,900	B's Capital	6,000
Stock		18,000		
C's Capital overdrawn		1,350		
		32,700		32,700

Debtors realised Rs. 10,500; stock Rs. 13,500 goodwill Rs. 600. Creditors were paid Rs. 17,250 in full settlement. In addition outstanding creditors, Rs. 150, were also paid, the expenses amounted to Rs. 180. A and B agreed to receive Rs. 900 in full settlement from C.

Show the Realisation Account, Cash Account and Capital Accounts of the partners.

Ans: *[Realisation Loss Rs. 7230, Deficiency on account of C Rs. 2619]*

NOTE:

When one partner becomes insolvent, Garner Vs Murray case is to be applied. i.e. the debit balance in insolvent partner's capital Account is to be debited to solvent partner's capital accounts in their final capital ratio. However, in order to calculate final capital ratio, the abnormal items like commission on realisation of assets, being expenses etc. are to be ignored.

55. The Balance Sheet of O, P, Q and R showed the following position on dissolution:

BALANCE SHEET

Dr.		*Cr.*	
Assets	*Rs.*	*Liabilities*	*Rs.*
Cash at Bank	34,000	Creditors	10,000
Q's Capital a/c	10,000	O's Capital	15,000
R's Capital a/c	3,000	P's Capital	10,000
		Realisation profit	12,000
	47,000		47,000

Show the final adjustment among the partners assuming that R is insolvent.

Ans: *[Amount received by O Rs. 18000, P Rs. 13000, cash brought in by Q Rs. 7000, no deficiency in R's account]*

56. P, Q, R and S were partners sharing profits and losses in the ratio of 3:3:2:2.

Following was their balance sheet as on 30th June 1994.

Assets		*Rs.*	*Liabilities*		*Rs.*
Cashat bank		2,000	Sundry Creditors		15,500
Sundry debtors	16,000		P's Loan		10,000
Less: Provision	500	15,500	Capital Accounts		
Stock		10,000	P	20,000	
Furniture and Fittings		4,000	Q	15,000	35,000
Trade marks		7,000			
Capital Accounts:					
R	16,000				
S	6,000	22,000			
		60,500			60,500

On 30th June, 1994 the firm was dissolved and Q was appointed to realise the assets and pay off the liabilities. He was entitled to receive 5 % commission on the amounts finally paid to other partners as capital. He was to bear the expenses of realisation. The assets realised as followed:

	Rs.
Sundry debtors	11,000
Stock	8,000
Furniture and fittings	1,000
Trade marks	4,000

Creditors were paid off in full, in addition a contingent liability for bills receivable discounted materialised to the extent of Rs. 2,500. Also there was a joint life policy for Rs. 30,000. This was surrendered for Rs. 3,000. Expenses of realisation amounted to Rs. 500. R was insolvent but Rs. 3,700 were recovered from his estate.

Write up the necessary accounts to close the books of the firm.

Ans: *[Realisation Loss Rs. 12000, Amount Received by P Rs. 11219, by Q Rs. 8581, Cash brought by S Rs. 8400, R's deficiency Rs. 14700]*

57. A, B and C are partners in a business sharing profits equally. Their Balance Sheet at 31st March 1994 is as follows:

Assets		*Rs.*	*Liabilities*		*Rs.*
Furniture		2,100	Sundry Creditors		10,000
Stock		15,400	Bills payable		2,000
Sundry debtors	18,000		Capital Accounts:		
Less: Provision	900	17,100	A	12,000	
C's Current Account		5,000	B	9,000	
Cash in hand		1,400	C	1,000	22,000
			Current Accounts:		
			A	2,000	
			B	2,000	4,000
			Reserve fund		3,000
		41,000			41,000

C is insolvent and his estate pays Rs. 1,800 to the firm. The partnership is consequently dissolved and sundry debtors, stock and furniture realise Rs. 23,600. Sundry creditors were settled at Rs. 8,000. You are required to prepare the necessary ledger accounts to close the books of the firm in accordance with the decision in Garner Vs Murray.

Ans: *[Realisation Loss Rs. 9000, Deficiency in C's account Rs. 4200]*

58. X, Y and Z were partners. Their Balance Sheet stood as under on the date when the firm was dissolved.

Assets	*Rs.*	*Liabilities*	*Rs.*
Sundry Assets	55,000	Sundry Creditors	60,000
Profit & Loss Account	12,000	X's Capital Account	22,000
Y's Capital Account	25,000	Z's Capital Account	10,000
	92,000		92,000

The assets realised Rs. 40,000. The expenses of realisation amounted to Rs. 1,000. The position of the partners was as follows:

	Private Estate	Private Liabilities
	Rs.	Rs.
X	18,000	20,000
Y	12,000	21,000
Z	12,000	10,000

Prepare the necessary ledger accounts to close the books of the firm.

Ans: *Realisation Loss Rs.16000 : Cash paid to Creditors Rs.41000.*

59. Furqan and Asghar are in equal partnership. Their Balance Sheet stood as under:

Assets	*Rs.*	*Liabilities*	*Rs.*
Plant and Machinery	13,750	Furqan's Capital	6,000
Furniture	5,000	Creditors	39,000
Debtors	5,000		
Stock	6,250		
Cash at bank	3,000		
Asghar's Drawings	12,000		
	45,000		45,000

The partnership was dissolved and the assets were realised as follows:

Stock Rs. 3,500; Furniture Rs. 3,000; Debtors Rs. 5,000 and Machinery Rs. 6,000.

The cost of collecting and distributing the estate amounted to Rs. 1,500. Furqan's private estate is not sufficient even to pay his private debts, whereas in Asghar's private estate there is a surplus of Rs. 500.

Prepare a Realisation Account, Cash Account and Profit and Loss Account/Deficiency account and Creditors Account showing what dividend is paid to creditors.

Ans: *[Realisation Loss Rs. 14000, Cash paid to Creditors Rs. 19500]*

60. Below is the Balance Sheet of M/s A, B and C as on December 31, 1994.

Assets	*Rs.*	*Liabilities*		*Rs.*
Cash	1,000	Sundry Creditors		40,000
Stock	24,000	A's Loan		10,000
Debtors	20,000	Capital Accounts:		
Furniture	3,000	A	5,000	
C's Capital (overdrawn)	10,000	B	3,000	8,000
	58,000			58,000

Due to the inability to pay the creditors, the firm is dissolved. B and C cannot pay anything. A can contribute only Rs. 1,500 from his private estate. Stock realises Rs. 15,000. Debtors realises Rs. 16,000 and furniture is sold for Rs. 1,000. Expenses amount to Rs. 3,000. Prepare accounts to close the books of the firm.

Ans: *[Realisation Loss Rs. 18000, Cash paid to creditors Rs. 31500]*

61. Moon, Light and shade were partners sharing profits in ratio 4 : 3 : 1. They want to dissolve the firm from the following Balance Sheet as on 31st March, 1994.

Balance Sheet 31.3.1994

Assets	*Rs.*	*Liabilities*		*Rs.*
Sundry Assets	18,500	Creditors		2,625
		Bank Overdraft		875
		Capital Accounts:		
		Moon	7,000	
		Light	3,000	
		Shade	5,000	15,000
	18,500			18,500

Capital should be repaid whenever the assets realised. Firm's assets realised as follows:

Months:	Rs.
May	2,000
July	1,500
September	2,500
October	4,000
December	6,500

No additional amount was realised.

From the above Balance Sheet and other information prepare the statement showing the interim distribution of cash.

Ans: *[Loss shared by Moon Rs. 1000, Light Rs. 750, Shade Rs. 250]*

CHAPTER - 20

JOINT VENTURE ACCOUNTS

JOINT VENTURE ACCOUNTS

It is sometimes in the mutual benefit of two or more persons or firms to run a specific business venture together instead of doing it separately. These are known as **Joint Ventures**. The profits of venture is then shared by the ventures. In fact, a joint venture is a form of partnership, but it is limited to a particular transaction. There may be several joint ventures as between the same parties, but each one is a separate venture, and the agreement may be different for each one, e.g. in respect of sharing of profits and losses. Joint ventures are not an outdated concept. In fact, they have become far important inrecent years.

Joint venture is, generally of short duration. Persons are known as coventurers and they do not use any firm or social name. Their liability is limited to the venture concerned. Joint venture may consist of joint consignment of goods, speculation in shares, underwriting of shares or debentures etc. As joint venture is limited partnership, therefore, in the absence of any agreement to the contrary the profits will be shared by the covertures in equal proportion.

MAIN FEATURES:

1. Since joint venture is for a single venture, generally, no firm name is used.
2. Two or more persons join together for a single venture.
3. Their association or partnership terminates on completion of the venture.
4. They share profits and losses in the agreed proportion. In the absence of any agreement, they share profit or loss equally.
5. Interest on capital, salary to coventurers may be paid as per agreement. In the absence of agreement, no interest or salary is payable.

DIFFERENCE BETWEEN PARTNERSHIP AND JOINT VENTURE:

S. No.	Basis	Partnership	Joint Venture
1	Nature	Partnership firm is generally of permanent nature	Joint venture is of temporary nature. It is for a specific venture.
2	Name	Partnership firm has a name.	Joint Venture generally has no name of the firm..
3	Members	In partnership maximum number of members is twenty and in case of banking business maximum number is ten.	In joint venture there is no limit of number of members.
4	Accounting	In Partnership detailed accounting is maintained.	In Joint Venture accounting is done in concise form.

5	Dissolution	Partnership can be dissolved by mutual consent of the partners or under certain circumstances.	Joint Venture will be dissolved automatically on the completion of the venture.
6	Bills of Exchange	In Partnership, a partner cannot draw a Bill of Exchange on other partner.	In joint venture one co–venturer may draw a Bill of Exchange on the other co–venturer.
7	Place of Accounting	In partnership, accounts are maintained at principal place of business of firm.	In joint venture accounts are maintained at one place or at several places or in the books of co-venturers.

DIFFERENCE BETWEEN CONSIGNMENT AND JOINT VENTURE:

S. No.	Basis	Consignment	Joint Venture
1.	Duration	Consignment is generally of long duration.	Joint venture is over after completion of a particular venture. Therefore, it is of small duration.
2.	Profit & Loss	In consignment profit or loss of consignment business belongs to consignor only.	In joint venture profit or loss belongs to all the co–venturers in an agreed ratio.
3.	Risk	In consignment all risk relating to goods is borne by consignor	In joint venture risk is borne by all the co-venturers.
4.	Relationship	In consignment mutual relationship between consignor and consignee is that of principal and agent.	In Joint Venture mutual relationship between co–venturers is that of partners and joint owners.
5.	Nature of business	In consignment, only moveable goods are sold by consignee.	Joint venture may be for immovable properties or for underwriting business also.
6.	Supply of Information	In consignment consignee supplies information regarding sales, expenses etc. to consignor.	In joint venture co-venturers may exchange information by exchange of copies of relevant accounts in their respective books.

MAINTENANCE OF ACCOUNTS:

Accounting treatment of the joint venture transactions will depend upon the method of recording the transactions followed by the concerned venturers. Usually practiced methods are stated below:

(1) WHEN RECORD IS KEPT ONLY AT THE PLACE OF BUSINESS:

Cases where most of the transactions of the joint venture are handled by one venturer only they may assign him the responsibility of keeping the record of the joint venture transactions also.

(2) WHEN COMPLETE RECORD IS KEPT BY ALL THE VENTURERS:

Under this method each venturer maintains personal accounts of all other venturers and one Joint Venture Account.

(3) MEMORANDUM METHOD:

Under this method each venturer records only such transactions of the venture as affect him personally. Joint venture account is written up on the basis of personal accounts maintained by the venturers. In this case Joint Venture account is maintained on memorandum basis.

(4) WHEN RECORD IS KEPT IN A SEPARATE SET OF BOOKS:

If the venture is big enough to justify separate set of books then this method is followed.

RECORDS KEPT AT THE PLACE OF BUSINESS

In case where most of the buying and selling on account of joint venture is ***managed by one of the venturers*** transactions may be recorded only at the place of business itself. The co–venturer appointed to manage the joint venture also undertakes the recording of transactions relating to the venture. In this case he has to maintain following additional accounts:

(a) Personal accounts of each co–venturer, and

(b) Joint Venture account.

The working of this method is outlined below:

JOURNAL ENTRIES:

1. ***For Cash supplied by the co–venturers:***

Cash/Bank Account .... Dr.

  Personal accounts of the venturers

2. ***For the purchase of goods for the venture:***

Joint Venture Account .... Dr.

  Cash Account

3. ***For goods supplied by the other co–venturers:***

Joint Venture Account .... Dr.

  Personal accounts of the venturers

4. ***For goods supplied by self:***

Joint venture Account .... Dr.

Purchases Account

5. ***For expenses paid by self:***

Joint Venture Account .... Dr.

Cash/Bank Account

6. ***For expenses incurred/paid by any other venturer:***

Joint Venture Account .... Dr.

Personal account of the venture

7. ***For sale of goods:***

Cash/Bank/Debtors Account .... Dr.

Joint Venture Account

8. ***For unsold stock taken over by self:***

Purchases Account .... Dr.

Joint Venture Account

9. ***For unsold stock taken over by any other venturer:***

Personal account of the venturer .... Dr.

Joint Venture Account

10. ***For sharing the profit on the joint venture:***

Joint Venture Account .... Dr.

Profit & Loss Account (with share of the self)

Personal accounts of other venturers (with the respective shares)

In case of loss on the joint venture above entry will be reversed.

11. ***For settling the accounts of the venturers:***

Personal accounts of other venturers .... Dr.

Cash/Bank Account

It should be noted that the personal account of each co–venturer discloses the amount receivable from or payable to him whereas Joint Venture account reveals the profit made or loss suffered on the joint venture.

ILLUSTRATION NO. 1

A and B enter into a joint venture and purchase an old house for Rs. 5,000; each contributing Rs. 2,500. For an agreed fee of Rs. 200 A is to arrange the disposal of the property. Sale of interiors, windows etc. amount to Rs. 1,500. A pays Rs. 200 for demolishing the house, the material of which realize Rs. 190. Sundry charges paid by A were Rs. 80 and the whole of the land is sold for Rs. 7,000. A and B share the net profits equally. A paying B his share by cheque.

You are required to journalize the entries and prepare Joint Venture account and B's account in the books of A.

Solution:

A'S BOOKS – JOURNAL

				Rs.	Rs.
	Bank account	Dr.		2,500	
	B account				2,500
	(Being B's share of investment received)				
	Joint Venture account	Dr.		5,000	
	Bank account				5,000
	(Being purchase of house on joint venture account)				
	Bank account	Dr.		1,500	
	Joint Venture account				1,500
	(Being the receipt from sale of interiors, windows etc.)				
	Joint Venture account	Dr.		200	
	Bank account				200
	(Being the payment of demolishing charges)				
	Bank account	Dr.		190	
	Joint venture account				190
	(Being amount received on sale of old materials)				
	Joint Venture account Dr.			80	
	Bank account				80
	(Being the payment of sundry expenses)				
	Bank account	Dr.		7,000	
	Joint Venture account				7,000
	(Being the receipt on account of sale of land)				
	Joint Venture account Dr.			200	
	Commission account				200
	(Being commission charged on the joint venture)				
	Joint Venture account	Dr.		3,210	
	Profit and Loss account				1,605
	B account				1,605
	(Being sharing of profit on the joint venture)				
	B account	Dr.		4,105	
	Bank account				4,105
	(Being amount remitted to B in settlement of his account)				

A'S LEDGER
JOINT VENTURE ACCOUNT

Dr. Cr.

		Rs.			Rs.
Bank A/c:			Bank A/c:		
Purchase of house	5,000		Sale of interiors etc.,	1,500	
Demolishing charges	200		Sale of old materials	190	
Sundry expenses	80	5,280	Sale of land	7,000	8,690
Commission A/c		200			
B's A/c – ($\frac{1}{2}$ share of profit)		1,605			
Profit and loss A/c ($\frac{1}{2}$ share of profit)		1,605			
		8,690			8,690

B'S ACCOUNT

Dr. Cr.

	Rs.		Rs.
Bank A/c	4,105	Bank A/c (contribution)	2,500
		Joint Venture A/c (profit)	1,605
	4,105		4,105

RECORDS IN THE BOOKS OF ALL VENTURERS – COMPLETE:

Under this method each venturer opens a joint venture account and the personal accounts of the other venturers. Suppose A and B enter into a joint venture then in A's Books joint venture account and the personal account of B will be opened. Similarly, in the books of B joint venture account and the personal account of A will be opened. The scheme of passing the journal entries in books of A and B is outlined below:

BOOKS OF A

(1)	For goods purchased for joint venture by A:	Joint Venture A/c Cash A/c (Being goods purchased for joint venture)	Dr.
(2)	For goods supplied from his own stock by A:	Joint Venture A/c Purchases/Sale A/c (Being goods supplied from stock)	Dr.

(3)	For expenses paid by A for joint venture:	Joint Venture A/c Cash A/c (Being expenses paid for joint venture)	Dr.
(4)	For goods supplied and expenses paid by B:	Joint Venture A/c B A/c (Being goods supplied/Expenses paid by B)	Dr.
(5)	For sales made by A:	Bank/Debtors A/c Joint Venture A/c (Being goods sold)	Dr.
(6)	For sales made by B:	B A/c Dr. Joint Venture A/c (Being goods sold by B)	
(7)	For Stock taken over by A:	Purchases A/c Joint Venture A/c (Being of stock taken over)	Dr.
(8)	For stock taken over by B:	B A/c Dr. Joint Venture A/c (Being stock taken over by B)	
(9)	For commission payable to A:	Joint Venture A/c Commission A/c (Being commission earned on joint venture sale)	Dr.
(10)	For Commission payable to B:	Joint Venture A/c B A/c (Being commission payable to B on joint venture sale)	Dr.
(11)	For B/R drawn on B:	Bills Receivable A/c B A/c (Being acceptance received from B)	Dr.

(12) For B/R discounted with bank:	Bank A/c	Dr.
	Discount A/c	Dr.
	B/R A/c	
	(Being B/R discounted with bank)	
(13) For discount transferred to J.V. A/c:	Joint Venture A/c	Dr.
	Discount A/c	
	(Being discount transferred to Joint Venture A/c)	
(14) For profit on joint venture:	Joint Venture A/c	Dr.
	P/L A/c	
	B A/c	
	(Being profit on joint venture transferred to P/L A/c and B's A/c)	
(15) For cash paid to B final settlement:	B A/c Dr.	
	Cash A/c	
	(Being cash paid to B in final settlement)	

NOTE:

Entries in the books of B will be made on the above basis. Balance of personal accounts will show same balance on the reserve side.

ILLUSTRATION NO. 2

X and Y were partners in a joint venture, sharing profits and losses in the ratio of 6:4. X supplied goods of the value of Rs. 6,000 and incurred an expenditure of Rs. 200. Y supplied goods of the value of Rs. 5,000 and his expenses amounted to Rs. 300. Y sold all the goods on behalf of the joint venture for a sum of Rs. 18,000. Y is entitled to a commission of 4 % on sales and he settled his account by sending a bank draft to X.

Pass Journal Entries in the books of X and Y.

Solution:

JOURNAL OF X

			Rs.	Rs.
Joint Venture A/c	Dr.		6,000	
Purchases A/c				6,000
(Being goods supplied for joint venture)				
Joint Venture A/c	Dr.		200	
Cash A/c				200
(Being expenses incurred)				
Joint Venture A/c	Dr.		5,000	
Y A/c				5,000
(Being goods supplied by Y for joint venture)				
Joint Venture A/c	Dr.		300	
Y A/c				300
(Being expenses incurred by Y)				
Y A/c	Dr.		18,000	
Joint Venture A/c				18,000
(Being goods sold by Y)				
Joint Venture A/c	Dr.		720	
Y A/c				720
(Being commission payable to Y @ 4 % on sales)				
Joint Venture A/c	Dr.		5,780	
P/L A/c				3,468
Y A/c				2,312
(Being profit on joint venture transferred to Profit & Loss A/c and Y's A/c)				
Bank A/c	Dr.		9,668	
Y A/c				9,668
(Being bank draft received in final settlement)				

JOURNAL OF Y:				
Joint Venture A/c	Dr.		6,000	
X A/c				6,000
(Being goods supplied by X)				
Joint Venture A/c	Dr.		200	
X A/c				200
(Being expenses paid by X)				
Joint Venture A/c	Dr.		5,000	
Purchases A/c				5,000
(Being goods supplied for joint venture)				
Joint Venture A/c	Dr.		300	
Cash A/c				300
(Being expenses paid)				
Bank A/c	Dr.		18,000	
Joint Venture A/c				18,000
(Being sales of goods)				
Joint Venture A/c	Dr.		720	
Commission A/c				720
(Being commission @ 4 % on sales)				
Joint Venture A/c	Dr.		5780	
Profit & Loss A/c				2312
X A/c				3468
(Being Profit on Joint Venture transferred to P/L A/c and X's A/c)				
X A/c	Dr.		9668	
Bank A/c				9668
(Being bank draft sent in final settlement)				

ILLUSTRATION NO. 3

A and B are partners in a joint venture sharing profits and losses in the proportion 4/5 and 1/5 respectively. A supplies goods of the value of Rs. 10,000 and incurs expenses amounting to Rs. 800. B supplies goods of the value of Rs. 8,000 and his expenses amount to Rs. 600. B sells goods on behalf of the joint venture and realizes Rs. 24,000. B is entitled to a commission of 5 % on sales. B settles his account by bank draft.

Give the journal entries and the relevant ledger accounts in the books of A.

Solution:

IN THE BOOKS OF 'A'

				Rs.	Rs.
	Joint Venture A/c	Dr.		10,800	
	Purchases A/c				10,000
	Cash A/c				800
	(Being the entry for purchases made of Rs. 10,000 and incurring expenses for Rs. 800)				
	Joint Venture A/c	Dr.		8,600	
	B A/c				8,600
	(Being the entry for contribution of B for joint venture)				
	B A/c	Dr.		24,000	
	Joint Venture A/c				24,000
	(Being the entry for sale proceeds of joint venture received by B)				
	Joint Venture A/c	Dr.		1,200	
	B A/c				1,200
	(Being the entry for 5 % commission on joint venture sale to B)				
	Joint Venture A/c	Dr.		3,400	
	Profit and Loss A/c				2,720
	B A/c				680
	(Being the entry for joint venture profit to P/L A/c and B's A/c)				
	Bank A/c	Dr.		13,520	
	B A/c				13,520
	(Being the sum due from B received)				

IN THE BOOKS OF A

JOINT VENTURE A/C

Dr.	Rs.		Cr. Rs.
Purchases	10,000	B A/c (Sale Proceeds)	24,000
Cash	800		
B A/c	8,600		
B A/c (Commission)	1,200		
B A/c (Share of Profit)	680		
Profit and Loss A/c	2,720		
	24,000		24,000

B'S ACCOUNT

	Rs.		Rs.
Joint Venture A/c	24,000	Joint Venture	8,600
		Joint Venture A/c (Commission)	1,200
		Joint Venture A/c (Share of Profit)	680
		Bank A/c	13,520
	24,000		24,000

MEMORANDUM METHOD

When all the venturers maintain accounts relating to joint venture but each venturer records only those transactions which are affected by him then the method is known as ***"Joint Venture Memorandum Method"***. This method is outlined below:

(1) Each venturer opens the personal accounts of other co–venturer in which he records transactions relating to the joint venture. This personal account of the co–venturer is headed as "Joint Venturer with ...... Account." For example if X and Y enter into a joint venture then in the books of X it will be "Joint Venture with Y Account" and in the books of Y it will be "Joint Venture with X Account".

(2) Transactions are recorded by the venturer with reference to "Joint Venture with ...... Account". i.e. one account involved of the journal entry is always "Joint Venture with ...... Account". For instance if goods are supplied and expenses met by X on account of joint venture then the entry in the books of X will be as follows:

Joint Venture with Y Account ....Dr.

Purchases Account .... (for goods supplied)

Cash Account .... (for expenses met)

Similarly, if the other venturer, say, Y affects sales and realizes each on behalf of the venture then the entry in the books of Y will be as follows:

Cash Account .... Dr.

Joint Venture with X Account .... (for sales affected and realized)

(3) To ascertain the profit of the joint venture "Memorandum Joint Venture Account is prepared in the books of all the venturers. Memorandum joint venture account is prepared exactly on the pattern of "Profit and Loss Account". On the basis of information supplied by the parties concerned all the transactions relating to the joint venture are entered in this account. Method of writing up this account is that enter all the debits appearing in the personal accounts of all the venturers on the debit side of Memorandum joint venture account and enter all the credits appearing in the personal accounts of all the venturers on the credit side of Memorandum joint venture account. Contra items, such as bills of exchange accepted by one venturer and drawn by another venturer or cash remitted by one venturer to another venturer, being eliminated. The difference in the two sides of the memorandum account is either a profit or loss. This loss or gain is divided among co–venturers in the agreed profit sharing ratio.

(4) For transferring profit on venture – own share of profit entry is:

Joint Venture with ...... Account Dr.

Profit and Loss A/c

For transferring loss on venture–own share of loss entry is:

Profit and Loss A/c Dr.

Joint Venture with ...... Account

(5) Joint venture with .... Account is balanced and difference is settled by paying/receiving cash.

ILLUSTRATION NO. 4

M and N entered into a Joint Venture for the purchase and sale of second–hand motor cars and to share profits and losses in the ratio of 3:2.

On January 15, 1993 M bought 5 cars for Rs. 43,000 and on January 20, 1993, he paid tax and insurance amounting to Rs. 1,600. On January 31, 1993, he sold these cars for Rs. 58,000 out of which he remitted Rs. 11,000 to N paying the balance into his own bank account.

On January 20, 1993, N bought 3 cars for Rs. 36,000 and on January 25, 1993, he paid tax and insurance Rs. 1,400 and repair charges amounting to Rs. 2,000. He sold one car on February 2, 1993

for Rs. 14,000 which he paid into his own bank account. M then took over other cars at a valuation of Rs. 26,000 and the venture was closed on February 10, 1993.

Prepare the Memorandum Joint Venture Account and the Account of the Joint Venture with N in the books of M.

Solution:

MEMORANDUM JOINT VENTURE ACCOUNT

Dr.								Cr.
				Rs.				Rs.
1993					1993			
Jan.	15	M – Purchases A/c		43,000	Jan.	31	M – Sales A/c	58,000
Jan.	20	M – Tax & Ins. A/c		1,600	Feb.	2	N – Sales A/c	14,000
Jan.	20	N – Purchases A/c		36,000	Feb.	10	M – Stock A/c	26,000
Jan.	25	N – Tax &						
		Ins. A/c	1,400					
		Repair A/c	2,000	3,400				
Feb.	10	Profits & Loss A/c:						
		M – 3/5th	8,400					
		N – 2/5th	5,600	14,000				
				98,000				98,000

IN M'S BOOKS
JOINT VENTURE ACCOUNT WITH N

Dr.							Cr.
			Rs.				Rs.
1993				1993			
Jan.	15	Bank (Purchases)	43,000	Jan.	31	Bank (Sales)	58,000
Jan.	20	Bank (Tax & Ins.)	1,600	Feb.	10	Cars A/c	26,000
Jan.	31	Bank A/c	11,000				
Feb.	10	Profit & Loss A/c					
		(Profit)	8,400				
Feb.	10	Bank	20,000				
			84,000				84,000

RECORDS IN A SEPARATE SET OF BOOKS:

Under this method joint venture is treated as a separate business entity and separate account books (Cash Book, Journal, Ledger etc.) are maintained. Main accounts prepared under this method are:

(A) Joint Bank Account (showing receipts and payment of cash),

(B) Joint Venture Account (showing purchase of goods, expenses, sale of goods, stock etc.) Balance of Joint Venture Account will show profit or loss of business and is distributed between conjecturers.

(C) Personal accounts of co–venturers (showing investments, entitlements of and receipts, drawings by co–venturers).

The specimen entries under this method are as follows: (assuming two parties are A and B).

(a)	For initial contribution of capital by co–venturers (A & B):	Joint Bank A/c
		  A A/c
		  B A/c
		(Being capital contributed by co–venturers)
			Dr.

(b)	For purchase of goods/expenses incurred out of Joint Bank Account:	Joint Venture A/c Joint Bank A/c (Being goods purchased/expenses incurred)	Dr.

(c)	For expenses paid personally by co–venturer:	Joint Venture A/c
		  A A/c
		  B A/c
		(Being expenses paid by A and B)
			Dr.

(d)	For goods purchased on credit:	Joint Venture A/c Creditors A/c (Being goods purchased on credit)	Dr.
(e)	For payment to creditors (out of Joint Bank):	Creditors A/c Joint Bank A/c (Being payment made to creditors)	Dr.
(f)	For sale of goods and proceeds deposited in Joint Bank A/c:	Joint Bank A/c Joint Venture A/c (Being goods sold for cash)	Dr.

(g)	For sale of goods and proceeds retained by co–venturer:	A A/c Dr. B A/c Dr. Joint Venture A/c (Being goods sold and proceeds retained by A and B)
(h)	For goods sold on credit:	Debtors A/c Dr. Joint Venture A/c (Being goods sold on credit)
(i)	For amount received from Debtors. (deposited in the Joint Bank (Account):	Joint Bank A/c Dr. Debtors A/c (Being amount received from debtors)
(j)	For stock taken over by co–venturer:	A A/c Dr. B A/c Dr. Joint Venture A/c (Being goods taken over by A and B)
(k)	For Commission/Interest payable to co–venturer:	Joint Venture A/c Dr. A A/c B A/c (Being Commission/Interest payable to A and B)
(l)	For profit on joint venture:	Joint Venture A/c Dr. A A/c B A/c (Being Profit on Joint Venture credited to A and B)

Note: In case of loss reverse entry will be passed.

(m)	For refund of Amount to co–venturers:	A A/c Dr. B A/c Dr. Joint Bank A/c (Being payment made to co–venturers)

ILLUSTRATION NO. 5

A, B and C enter into a joint venture to divide profits equally. They bought goods from D & Co. for Rs. 12,500 and from A for Rs. 2,500. A contributed Rs. 3,000, B Rs. 4,000 and C Rs. 9,000 which amounts were banked in a joint account. They settled their account with D & Co. by cheque and paid for carriage and other expenses Rs. 750. They sold goods for cash Rs. 6,500 and to Rehman & Co. on credit for Rs. 14,000 who accepted draft for the amount. The acceptance was encashed and realized Rs. 13,700. A was allowed 5 % commission on sales for effecting the transactions.

Pass journal entries and open the necessary accounts assuming that the final settlement between the parties was made by cheques.

Solution:

JOURNAL ENTRIES

			Rs.	Rs.
	Joint Bank Account	Dr.	16,000	
	A Account			3,000
	B Account			4,000
	C Account			9,000
	(Being the cash introduced by the co-venturers and banked in a joint account)			
	Joint Venture Account	Dr.	15,000	
	D & Co. Account			12,500
	A Account			2,500
	(Being the credit purchases for the joint venture)			
	D & Co. Account	Dr.	12,500	
	Joint Bank Account			12,500
	(Being the payment to D & Co. on account)			
	Joint Venture Account	Dr.	750	
	Joint Bank Account			750
	(Being the payment of carriage and other expenses)			

Joint Bank Account	Dr.	6,500	
Rehman & Co. Account	Dr.	14,000	
Joint Venture Account			20,500
(Being the cash and credit sales of the venture)			
Bills Receivable Account	Dr.	14,000	
Rehman & Co. Account			14,000
(Being the acceptance of our bill by Rehman & Co.)			
Joint Bank Account	Dr.	13,700	
Discount Account	Dr.	300	
Bills Receivable Account			14,000
(Being the amount realized on discounting the bill)			
Joint Venture Account	Dr.	300	
Discount Account			300
(Being the transfer of discount to the joint venture account)			
Joint Venture Account	Dr.	1,025	
A Account			1,025
(Being 5 % commission on sales payable to A)			
Joint Venture Account	Dr.	3,425	
A Account			1,141.67
B Account			1,141.67
C Account			1,141.66
(Being profit on venture credit to venture's personal accounts)			
A Account	Dr.	7,666.67	
B Account	Dr.	5,141.67	
C Account	Dr.	10,141.66	
Joint Bank Account			22,950.00
(Being the settlement of venturers' accounts by cheques)			

JOINT VENTURE ACCOUNT

	Rs.	P.		Rs.	P.
D & Co. (purchases)	12,500	00	Joint Bank Account (cash sales)	6,500	00
A (purchases)	2,500	00	Rehman & Co. (credit sales)	14,000	00
Joint Bank A/c (expenses)	750	00			
Discount	300	00			
A (Commission)	1,025	00			
A (profit shared)	1,141	67			
B (profit shared)	1,141	67			
C (profit shared)	1,141	66			
	20,500	00		20,500	00

JOINT BANK ACCOUNT

	Rs.	P.		Rs.	P.
A A/c	3,000	00	D & Co. A/c	12,500	00
B A/c	4,000	00	Joint Venture A/c (expenses)	750	00
C A/c	9,000	00	A A/c	7,666	67
Joint Venture A/c	6,500	00	B A/c	5,141	67
Bills Receivable A/c	13,700	00	C A/c	10,141	66
	36,200	00		36,200	00

Dr. **A'S ACCOUNT** Cr.

	Rs.	P.		Rs.	P.
Joint Bank A/c	7,666	67	Joint Venture A/c (goods)	2,500	00
			Joint Venture A/c (commission)	1,025	00
			Joint Venture A/c (profit share)	1,141	67
			Joint Bank A/c	3,000	00
	7,666	67		7,666	67

B'S ACCOUNT

	Rs.	P.		Rs.	P.
Joint Bank A/c	5,141	67	Joint Bank A/c	4,000	00
			Joint Venture A/c (profit)	1,141	67
	5,141	67		5,141	67

C'S ACCOUNT

	Rs.	P.		Rs.	P.
Joint Bank A/c	10,141	66	Joint Bank A/c	9,000	00
			Joint Venture A/c (profit)	1,141	66
	10,141	66		10,141	66

ILLUSTRATION NO. 6

Asim and Mohsin, doing separate business as engineers and contractors, undertook jointly to construct the factory building of the Faisal & Co. Ltd. for a contract price of Rs. 60,000 payable 75 per cent in cash and the balance in shares of the company. A banking account was opened in their joint names, Asim paying Rs. 20,000 and Mohsin Rs. 15,000. They agreed to share profit or loss in the proportion of 3/5 and 2/5 respectively. Their transactions were as follows:

	Rs.
Cost of materials paid	**30,000**
Wages paid	**15,000**
Materials supplied by Asim	**2,000**
Materials supplied by Mohsin	**3,000**
Establishment expenses paid	**5,000**

The contract was completed and price duly received, 50 per cent of the share received were sold at Rs. 6,000 and the balance was taken by Asim and Mohsin equally at an agreed valuation of Rs. 5,000. The stock of materials was taken by Asim at Rs. 3,000.

You are required to show necessary accounts in the joint books of the venture.

Solution:

JOINT VENTURE ACCOUNT

Dr.	Rs.		Cr. Rs.
Joint Bank – Cost of materials	30,000	Joint Bank A/c	
— Wages	15,000	75 % of contract price	45,000
Asim–Material supplied	2,000	Shares account	
Mohsin–Material supplied	3,000	25 % of contract price	15,000
Joint Bank–Establishment exp.	5,000	Asim–Materials taken	3,000
Shares account loss	4,000		
Asim – 3/5th of profit	2,400		
Mohsin – 2/5th of profit	1,600		
	63,000		63,000

JOINT BANK ACCOUNT

	Rs.		Rs.
Asim's account	20,000	Joint venture account:	
Mohsin's account	15,000	Cost of materials	30,000
Shares account	6,000	Wages	15,000
Joint venture account	45,000	Establishment expenses	5,000
		Asim's account	18,900
		Mohsin's account	17,100
	86,000		86,000

SHARES ACCOUNT

	Rs.		Rs.
Joint venture account	15,000	Joint bank account	6,000
		Asim's account	2,500
		Mohsin's account	2,500
		Joint venture account	
		Loss on shares	4,000
	15,000		15,000

ASIM'S ACCOUNT

	Rs.		Rs.
Joint venture account:		Joint bank account	20,000
Material taken back	3,000	Joint venture account:	
Shares account	2,500	Materials	2,000
Joint bank account	18,900	Share of profit	2,400
	24,400		24,400

MOHSIN'S ACCOUNT

	Rs.		Rs.
Shares account	2,500	Joint bank account	15,000
Joint bank account	17,100	Joint venture account:	
		Materials	3,000
		Share of profit	1,600
	19,600		19,600

QUESTIONS

1. Define a "Joint Venture".
2. What are the different methods of recording transactions relating to joint venture?
3. What is memorandum joint venture account?
4. Differentiate between joint venture account and joint venture with – account.
5. When records of a joint venture are maintained in different books, how is the profit ascertained?

PROBLEMS

1. E and F enter into Joint Venture sharing profit 3/5 th and 2/5 th E is to purchase timber and forward it to F. E purchased timber worth Rs. 20,000 and paid Rs. 2,000 as expenses. F received the consignment and immediately accepted E's draft for Rs. 16,000. E got it discounted for Rs. 15,750 F disposed of the timber for Rs. 32,000. He had to spend Rs. 700 for fire insurance and Rs. 600 for rent. Under the agreement, he is entitled to a commission of 5 % on sales.

   Give ledger accounts in the books of E.

Ans: *[Profit Rs. 6850]*

2. Shahid and Rashid entered into a Joint Venture agreeing to share profit equally and the following transactions took place:

	Rs.
Shahid purchased goods	16,000
Rashid paid carriage and freight	1,000
Rashid sold goods amounting to	12,000
Rashid paid Commission on sale	200
Shahid paid storage fees amounting to	400
Shahid sold remaining goods for	10,000
Shahid paid commission and carriage	1,000

   Show the transaction in Shahid's books and the Joint Venture Account.

Ans: *[Profit Rs. 3400]*

3. Tufail and Naeem entered into a Joint Venture for the purchase and sale of second– hand motor cars and to share profits and losses in the ratio of 3:2.

   On 15th January 1990 Tufail purchased 5 cars for Rs. 4,30,000 and on 20th January 1990 he paid taxes and insurance of Rs. 16,000. On 31st January 1990 he sold these cars for Rs. 5,80,000. Out of the sale proceeds he remitted Rs. 1,10,000 to Naeem paying the balance of the amount in his own bank account.

   On 20th January 1990 Naeem purchased 3 cars for Rs. 3,60,000 and on 25th January 1990 he paid taxes and insurance amounting to Rs. 14,000 and repair charges amounting to Rs. 20,000. He sold one old car on 2nd February 1990 for Rs. 1,40,000 and paid the sale proceeds into his own bank account. Tufail then took over the other cars at a valuation of Rs. 2,60,000 and the venture was closed on 10th February 1990.

   Show the Joint Venture Account in the books of both Tufail and Naeem.

Ans: *[Profit Rs. 140,000]*

4. Javed bought fancy goods for Rs. 23,000 which he consigned to Khalid for the sale on Joint Account, the profits to be shared equally. Javed spent Rs. 400 for carriage and insurance on goods. He drew a three months' bill on Khalid for Rs. 10,000 and discounted the same for Rs. 9,980.

On receipt of the goods, Khalid paid Rs. 200 for freight and Rs. 50 for storage. He sold the whole of the goods for Rs. 30,000, his commission in connection therewith being Rs. 150. Immediately on realization of the sale proceeds, he rendered an Account Sales to Javed enclosing a sight draft for the amount due to him.

Write up accounts in the books of both the parties.

Ans: *[Profit Rs. 6180]*

5. Waqar of Karachi purchased 1,000 meters of China silk at Rs. 6 per meter and sent it to Asad of Lahore to be sold for mutual benefit. Waqar spent Rs. 200 on packing etc. Asad received the consignment and paid Rs. 500 as freight.

Waqar drew upon Asad for Rs. 5,000. The draft was accepted and Waqar got it discounted for Rs. 4,850. Asad sold 900 meters at Rs. 9 per meter and had to pay Rs. 252 as expenses.

Waqar took over the remaining quantity at cost plus 10 %, Waqar is to be allowed a commission on sales at 5 % and profits are to be shared in the ratio of Waqar 3/5 and Asad 2/5.

Prepare ledger accounts in the books of both the parties.

Ans: *[Profit Rs. 1330]*

6. Mr. 'A' of Lahore and Mr. 'B' of Karachi agreed to consign 100 bales of cotton to Mr. 'C' of Peshawar for Joint Purpose. Profits and Losses are to be shared by A and B equally.

A consigned 50 bales at the rate of Rs. 1,200 each. His expenses were Rs. 1,200. B consigned 50 bales at the rate of Rs. 1,100 each. His expenses were Rs. 900.

During transit 5 bales were tampered and A collected Rs. 3000 in full settlement from the insurer. C sold the remaining bales for Rs. 1,35,000. His expenses were Rs. 15,000 and he is eligible for a commission of 3 % on sales.

C remitted a bank draft for the balance due to be payable at Lahore. Prepare ledger accounts in the books of the partners.

Ans: *[Profit Rs. 1850]*

7. A and B enter into a Joint Venture and agree to share profits and losses equally. It is also agreed between them that A should make purchases for the Joint Venture at Multan, where he resides and consign the same to B at Karachi.

Accordingly, A purchased goods worth Rs. 70,000 and sent them to Karachi and in so doing he had to pay Rs. 1,500 for insurance and Rs. 3,750 for carriage, freight and other expenses.

B reported after sometime that he had sold some goods for Rs. 69,000 and the remaining goods could not be sold on account of bad market conditions. A and B then handed over the unsold goods to a local merchant, C, at Karachi who agreed to sell the goods on their behalf.

C was to be paid all the expenses in that connection and was to be allowed a commission at the rate of 10 % on the sale price of the goods sold.

C, after sometime, sent to B a cheque for Rs. 4,500 after deducting expenses Rs. 180 and commission. The sale price of goods sold by C was Rs. 5,200. C returned the unsold goods to B.

A and B then decided to close the Joint Venture, B taking up the balance of the goods unsold which had cost Rs. 25,000 at a discount of 8 %.

B sent a statement of account to A showing the following payments made by him.

Carriage, Rs. 1,500; office expenses, Rs. 2,500; insurance Rs. 3,000; office and godown rent Rs. 1,500; Brokerage, Rs. 3,500.

He also sent a cheque for Rs. 70,000 to A.

You are required to prepare the necessary accounts in A's ledger showing his share of profit or loss on the Joint Venture and the amount due to or by B.

Ans: *[Profit Rs. 9250, Amount due from B Rs. 5375]*

8. Nadeem in Lahore enters into a Joint Venture with Ali in Karachi to sell articles at D.G. Khan through an agent Waheed. Nadeem sends articles valued Rs. 90,000, pays freight etc. Rs. 4,500 and sundry expenses Rs. 4,725. Ali sends goods worth Rs. 62,250 and pays freight etc. Rs. 7,200. Ali receives Account Sales and net proceeds from Waheed for the whole of the goods amounting to Rs. 2,40,000. Show how these transactions appear in the books of Nadeem and Ali if balance is settled by cheque.

Ans: *[Profit Rs. 71325]*

9. Ramiz and Raja have taken up a contract in July 1990 as a Joint Venture to lay roads in an industrial establishment for Rs. 3,00,000. Ramiz brought in Rs. 40,000 and Raja Rs. 30,000 as capital; these amounts were deposited in a joint bank account which was opened for this purpose. They agreed to share profit or loss equally. The work was completed on 30th June 1991 and the following expenses were incurred and paid for from the joint bank account:

Materials	Rs. 1,00,000
Wages	Rs. 50,000
Machinery & Stores	Rs. 30,000

Payments from the industrial establishment were received periodically and remitted into the joint bank account; but 1 % of the contract amount was not paid because of defective work. They agreed to provide depreciation on machinery and stores at 10 % for the year ending on 30th June 1991. Half of the machinery and stores was purchased by Raja at book value; the other half was sold at a profit of 10 % on the book value to outsiders.

Prepare necessary accounts in the ledger of the Joint Venture.

Ans: *[Profit Rs. 145350]*

10. M and N doing business separately as building contractors, undertake jointly to construct a building for a contract price of Rs. 6,00,000. A bank account is opened in their joint names, M paying in Rs. 1,50,000 and N Rs. 1,00,000. They are to share profit or loss in the ratio of 2:1. Their transactions were as follows:

	Rs.
Paid wages	1,00,000
Bought Materials	2,80,000
Materials supplied by M	20,000
Materials supplied by N	30,000
Architect's fees paid by N	8,000

The contract was completed. Payment was received in installments but due to certain defects, a bill of Rs. 20,000 was not paid. The Joint Venture was closed by M taking up the stock of materials at an agreed valuation of Rs. 20,000.

Separate books were maintained for the Joint Venture. Show the necessary Ledger Accounts.

Ans: *[Profit Rs. 162000]*

11. Adnan and Irfan both building contractors undertook jointly the construction of a building for Joint Stock Company for a contract price of Rs. 1,20,000 to be paid in shares in an agreed value of Rs. 12 per share which were later on disposed of at Rs. 12.50 per share. A bank account is opened in their joint names, Adnan paying Rs. 25,000 and Irfan Rs. 15,000. They are to share profit and losses in the proportion of 2/3 and 1/3 respectively. Their transactions were as follows:

	Rs.
Salary paid and outstanding	4,000
Wages paid	18,000
Wages outstanding	2,000
Materials bought	60,000
Materials supplied by Adnan	5,000
Materials supplied by Irfan	4,000
Architect's fees paid by Adnan	2,000
Carriage	6,000

The contract was completed and the price was duly received. Irfan took over the stock of materials at an agreed valuation of Rs. 3,000. Show the necessary accounts.

Ans: *[Profit Rs. 27000]*

12. Shah and Malik entered into a Joint Venture to produce an advertising film to a big company. Company accepted to pay Rs. 1,50,000. Shah and Malik opened a Joint Bank Account in their names, Shah paying in Rs. 30,000 and Malik Rs. 25,000. They are to share profit and losses equally. Their transactions were as follows:

	Rs.
Paid wages	40,000
Goods purchased	25,000
Purchased Camera	5,000
Sets supplied by Shah	5,000

The film production was completed by Malik taking up camera for Rs. 2,000 and Shah, sets for Rs. 1,000. But due to some defects in the film, the company paid the agreed amount after deducting 20 %.

Show Joint Bank Account, Joint Venture Account, Shah's Account and Malik's Account.

Ans: *[Profit Rs. 48000]*

13. A, B and C jointly undertake to erect a theatre building for Subhan Pictures Ltd. at a price of Rs. 5,00,000 to be paid as to Rs. 4,00,000 in cash by installments, and Rs. 1,00,000 in Debentures of the company.

They contribute: A Rs. 60,000, B Rs. 75,000 and C Rs. 40,000. These amounts are deposited in a Joint Bank Account.

A gets the plans prepared and pays Rs. 7,000 architects' fees. B brings into the venture a concrete mixer of the value of Rs. 25,000 and C brings into the venture a motor truck of the value of Rs. 20.000.

They buy a plant for Rs. 24,000. Materials worth Rs. 2,40,000 are purchased for cash and Rs. 1,95,000 are paid for wages.

On completion of the venture, A takes over unused materials to the value of Rs. 14,000; B takes back the concrete mixer at a valuation of Rs. 12,000; and C takes back the motor truck at Rs. 8,000. The plant is sold as scrap for Rs. 6,000. When the contract price was fully received, A took over the Debentures at a valuation of Rs. 80.000.

Show the Joint Venture Account, the Joint Bank Account and the accounts of the venturers, after the final distribution and the settlement of accounts.

Ans: *[Profit Rs. 9000]*

14. A and B are doing business separately as engineering contractors. They undertake jointly to build and install new machinery for a company for a contract Price of Rs. 1,34,000, of which Rs. 84,000 is payable in installments in cash and the balance as fully paid shares in the new company. A bank account is opened jointly in the names of A and B, A paying Rs. 45,000 and B Rs. 20,000. They are to share profits and losses in the proportions of 3/5 and 2/5, respectively. Their transactions were as follows:

	Rs.
Amount advanced to suppliers for supply of materials	52,000
Value of materials supplied by suppliers	89,000
Balance amount paid to suppliers in full and final settlement	35,500
Paid wages	36,000
Materials purchased for cash	2,500
Materials supplied by A from his stock	9,250
Engineering consultant fees paid	3,250
Value of stock lost by fire and not covered by insurance	3,500

The contract was completed and the price duly received.

A took all the shares at an agreed value of Rs. 47,000 and B took the balance of stock of materials worth Rs. 3,500 at an agreed value of Rs. 2,750.

Prepare the Joint Venture Account, A's Account, B's Account, Shares Account and Joint Bank Account and find out the profit or loss on the Joint Venture.

Ans: *[Loss Rs. 4750]*

CHAPTER - 21

ACCOUNTS OF JOINT STOCK COMPANIES

ACCOUNTS OF JOINT STOCK COMPANIES

INTRODUCTION:

A Joint Stock Company is a type of business organisation which is formed under Companies Ordinance 1984, whose capital is contributed by members who are accorded the privilege of limited liability. This means that they are liable for the debts of the company to the extent of the shareholding that they have contributed. Beyond that sum they are not liable for the company's debts. The Joint Stock Company is the only practicable way of collecting the vast sum of capital required for the complex industrial projects of the modern world.

DEFINITION OF A JOINT STOCK COMPANY:

A joint stock company may be defined as an artificial person recognized by law, with a distinctive name, a common seal, a common capital comprising transferable shares carrying limited liability and having a perpetual succession.

The main characteristics of a company which distinguish it from other forms of organizations are as follows:

CHARACTERISTICS OF A JOINT STOCK COMPANY:

1. SEPARATE LEGAL ENTITY:

A joint stock company is the creation of law. It has a separate legal entity of its own which is recognized by law as distinct from the persons forming it. The company enjoys many of the rights of natural person. For example, it can use or be used in its name. It can own and transfer the title to property.

2. FINANCING:

A joint stock company is an effective organization for raising a large amount of capital. It issues prospectus and invites people to purchase the shares of the company. The persons who purchase shares become part owners of the company with liability limited to the value of the shares they have purchased.

3. PERPETUAL EXISTENCE:

A joint stock company has a long life compared to other forms of business organizations. When company is formed and commences business, it has then a continuous life. The shareholder can withdraw the capital by selling shares in the market. The company can, however, be winded up through compliance with the provisions of Companies Ordinance 1984.

4. LIMITED LIABILITY:

The liability of each shareholder of the company is limited only to the extent of the face value of the shares he holds or any part thereof which is unpaid.

5. TRANSFERABILITY OF SHARES:

The shareholders of a company have full freedom to transfer their shares to other without consulting other shareholders.

6. SEPARATION OF OWNERSHIP FROM MANAGEMENT:

The shareholders, who are the owners of the company, are large in number. They are scattered all over the country. Being absentee owners, they cannot manage the affairs of the company. The shareholders, therefore, elect Board of Directors in the annual general meeting and entrust the management of the company to them. The ownership and management of the company are thus in two separate hands.

7. STATUTORY REGULATIONS:

A company right from its inception, has to comply with a number of statutory requirements. It has also to submit returns and report during its lifetime to the Government.

8. COMMON SEAL:

Since the company is an artificial person created by law, it therefore cannot sign documents for itself. The common seal with the name of the company engraved on it is, therefore, used as a substitute for its signature.

9. RIGIDITY OF OBJECTS:

In a company form of organization, the objects and powers of the company are set out in the memorandum of association of the company. A change in the object and powers of a company can only be made after complying with the relevant provisions of the Companies Ordinance.

KINDS OF COMPANIES

There are four kinds of companies registered under companies ordinance, 1984.

(1) COMPANY LIMITED BY SHARES:

This is the principal form of company which is registered with the registrar of joint stock companies under the Companies Ordinance. In a company limited by shares, the capital is divided into a number of shares. A person who buys one or more than one shares becomes a member of the company. The shares can be freely transferred and sold. The liability of the members is limited to the amount if any, unpaid on the shares held by them. A company limited by shares is further divided into (a) private company and (b) Public company.

(a) Private Limited Company:

According to the Companies Ordinance 1984 it can be formed (a) at least by two persons and its total membership cannot exceed 50. (b) The company by its articles also restricts the right to transfer its shares. (c) It also prohibits any invitation to the public to invest their money in shares of debentures of the company.

(b) Public Limited Company:

It can be formed by at least seven members and there is no limit to the maximum number. The public limited company invites applications from investors through advertisement in the newspapers, giving full details of the objects, share capital, method of applying for the procedure to be adopted for the allotment of the shares etc.

(2) COMPANY LIMITED BY GUARANTEE. SECTION 15(2) (b)

It is the company in which the liability of its members is limited by the memorandum of association to such amount as the members may respectively undertake to contribute to the assets of the company in the event of its being wound up. This type of company is formed mostly when work is of non–profit making nature.

(3) UNLIMITED COMPANY:

An unlimited company is that in which the liability of its members is unlimited. Every member of the company is personally liable to the full extent of his personal assets for all the debts of the company while he was a member. The unlimited companies due to great risk do not exist here.

(4) ASSOCIATION NOT FOR PROFIT:

Association not for profit is registered under Section 42 of the Companies Ordinance. It enjoys all the privileges of a limited company without using the word limited or private limited. This association is mainly formed for the promotion of commerce, art, religion, charity etc. The Federal Government grants the licence for the association.

NOTE:

In this chapter, the whole discussion is about the accounting of Public Limited Companies.

FORMATION OF A PUBLIC LIMITED COMPANY:

The establishment of Public Limited Company is not an easy job. A number of steps need to be taken for the formation of a public company. However, these are split up into three stages (1) Promotion (2) Incorporation and (3) Commencement of business.

(1) PROMOTION OF A COMPANY:

The important steps in the promotion of a company are (1) Discovery of business idea (2) Investigation of the business project (3) Verification of the results of investigation. (4) Chalking out a definite course of action for establishing a company (5) Financing of the business.

(2) INCORPORATION OF A COMPANY:

The promoters have to prepare and file a number of documents with the registrar for the incorporation of a company. These documents are as under:

1. The memorandum of association.
2. The articles of association.

3. Notice of the address at which the registered office of the company will be situated.

4. A statutory declaration by the secretary or a chartered accountant that all the provisions of the Companies Ordinance with regard to registration have been fulfilled.

5. Original copies of the receipted challans in respect of payment of duty on share capital and the prescribed filing fee.

The above documents when submitted must be accompanied with requisite filing fee. The registrar on receipt of all the documents will scrutinize them. If he is satisfied that the requirements of law have been fully met with, he will register the company on the Register of Companies and issue a certificate of Incorporation. The certificate of incorporation is a proof of the fact that all the requirements of the Companies Ordinance have been complied with.

DOCUMENTS TO BE FILED AFTER INCORPORATION:

After incorporation, the following documents are to be filed with the registrar.

1. A list of persons along with addresses who have agreed to act as directors and their consent do so within 7 days of the issue of certificate of incorporation.

2. The address of the office of the company within 28 days of the incorporation of the company.

3. Prospectus on or before the date of its publication.

COMMENCEMENT OF BUSINESS:

A private limited company can commence business on receipt of certificate of incorporation. A public company has, however, to wait to commence business till a certificate of commencement of business is received from the registrar of the joint stock companies. The certificate of commencement of business is granted on fulfilling the following a few other requirements.

(1) Where prospectus has been issued inviting the public to subscribe for shares:

(a) Shares payable in cash have been alloted to the amount of minimum subscription.

(b) Every director of the company has paid the full amount of the shares payable in cash.

(c) There is no money liable to be repaid to applicants for shares which have been offered for subscription.

(d) A statutory declaration by the chief executive or one of the directors and the secretary, that the aforesaid conditions have been compared with.

The registrar on being fully satisfied that (a) the verified declaration has been filed and (b) all other requirements of the Ordinance have been complied with, will issue a certificate called, "certificate of commencement of business". On receipt of this 'certificate' a company is entitled to commence business.

A company which has not issued prospectus shall have to file 'a statement in lieu of prospectus' for getting the 'certificate of commencement of business'.

IMPORTANT LEGAL DOCUMENTS OF A PUBLIC LIMITED COMPANY

The three legal basic documents of a joint stock company are (1) Memorandum of Association, (2) Articles of Association and (3) Prospectus. These are now discussed in brief.

1. MEMORANDUM OF ASSOCIATION:

Memorandum of association is the basic document of the company. It is known as the charter of the company. It contains the fundamental conditions upon which alone company can be incorporated. It sets out the limits outside which the action of the company cannot go.

The purpose of memorandum of association is to enable shareholders and creditors and all those who deal with it to know its permitted range of enterprise. The memorandum of association, therefore, must be prepared carefully. It must be printed, divided into suitable paragraphs, consecutively numbered and signed by everyone of the seven subscribers in case of a public company and two in the case of a private limited company.

The contents of the memorandum of association as required by Sections 16, 17 and 18 of the Companies Ordinance include the following clauses (1) Name clause (2) situation clause (3) object clause (4) liability clause (5) capital clause and (6) subscription clause.

2. ARTICLES OF ASSOCIATION:

The articles of association is the second important document in the incorporation of a company. It is the document which contains the rules and regulations for the internal management of the company. The articles of association embody the power of directors and other officers of the company, the right of voting of the shareholders, the procedure of holding meeting, the manner of transferring the shares, the procedure of issuing the shares debenture, the payment of dividends, maintenance of accounts, alteration of capital, winding up etc. etc.

The articles of association is subordinate to the memorandum. It cannot include any power which is prohibited or excluded by the Memorandum and the Companies Ordinance.

According to Section 26 of the Companies Ordinance, a company limited by shares can choose to adopt table 'A' in the First Schedule which contains model rules and regulations.

The articles of association shall be printed, divided into paragraphs, numbered consecutively, signed by each subscriber and dated.

The articles of association subject to the provisions of Ordinance can be altered or added by special resolution.

3. PROSPECTUS:

It is a valuable document issued by the company for raising of the capital.

Prospectus has been defined as "any document described or issued as prospectus and includes any–notice, circular, advertisement or other communication, inviting offers from the public for the subscription or purchase of any shares".

The main object of prospectus is to arouse the interest of the investors in the proposed company and to induce them to invest in its shares and bonds etc.

The prospectus gives the details of the amount issued, the rights attached to the shares the property purchased; information about directors, auditors, bankers etc.

SHARE CAPITAL OF A JOINT STOCK COMPANY

In today's world large scale operations of a company call for a large amount of capital. The total amount of capital is divided into smaller units. These units are called **shares.** Each share is assigned a value. This value is called the **par value** of the share. The total capital is thus divided into a large number of shares. This pool is, therefore, called **share capital**. This scheme of raising capital through shares (i) helps the company to raise a large amount, and (ii) helps a larger section of the investment population to benefit from the operations of large scale business concerns.

A company has to fulfil certain legal requirements if, in later yeas, it decides to either increase or decrease its share capital. And it has to state its maximum capital in the memorandum. To minimize the chances of undergoing legal formalities in later years, therefore, it is customary to state a reasonable amount as the maximum capital. This amount is incorporated in the memorandum of association and is known as the authorized capital, nominal capital, or registered capital of the company. Various terms used in relation to share capital are explained in the following paragraphs.

AUTHORIZED CAPITAL:

It is the amount of capital with which the company is registered. This capital is mentioned in the memorandum of association. A mention is also made of the number of shares into which this total capital is divided, and of the par value of shares. In later years, if the company wants to either increase or decrease this capital, certain legal requirements must be met. This capital is also known as nominal capital or registered capital.

ISSUED CAPITAL:

Shares offered to the general public for contribution are known as shares issued. The total par value of such shares is called issued capital. To begin with, a company seldom offers all of its shares for subscription. Therefore, the amount of issued capital is generally less than the authorized capital. If a company has an authorized capital of Rs. 10,00,000 divided into 10,000 shares of Rs. 100 each, it may decide to offer 5,000 shares to the general public. In this case the issued capital is said to be Rs. 5,00,000 divided into 5,000 shares of Rs. 100 each. The remainder, that is, the difference between the authorized and issued capital is known as unissued capital.

SUBSCRIBED CAPITAL:

Out of the total number of shares offered (issued) by the company, that number of shares which is taken up by the public is known as shares subscribed. The total par value of such shares is called subscribed capital. For example, out of the 5,000 shares issued by the company, if the public takes up 4,500 shares, the subscribed share capital is Rs. 4,50,000 (4,500 shares × Rs. 100 par value of each share).

CALLED–UP CAPITAL:

A company may require payment of the par value either in instalments or in one lump sum. This amount is known as the called–up capital. For example, for each of the 4,500 shares taken up by the public the company may require a payment of Rs. 70 per share (the remainder Rs. 30 per share to be paid when asked for by the company. In this case the called–up capital of the company is Rs. 3,15,000 (4,500 × Rs. 70 per share called–up). The difference between the subscribed capital and the called–up capital is known as un–called capital. In this case the un–called capital is Rs. 1,35,000 (Rs. 4,50,000 subscribed capital minus Rs. 3,15,000 called–up capital or 4,500 shares subscribed × Rs. 30 per share uncalled. According to Companies Ordinance, 1984, shares are always issued at full price (full amount is called up on application). Therefore, there is no difference between subscribed and called capital.

PAID–UP CAPITAL:

The total amount received by the company out of the total called–up amount is known as the paid–up capital. Assuming that of Rs. 3,15,000 called–up capital the company received Rs. 3,00,000; the paid–up capital is in the amount of Rs. 3,00,000. The remainder of Rs. 15,000 is known as calls unpaid or calls in arears. Now-a-days the total par value is collected at the time of application and as such practically there are no calls in arrears. Presently, therefore, the subscribed, called–up and paid–up capitals are in the same amount.

RESERVE CAPITAL:

It is the portion of the subscribed capital which the company, through a special resolution, reserves to call in the event of winding up. Assume that 4,500 shares Rs. 100 are subscribed, the company decided to call Rs. 70 per share and passed a special resolution to the effect that Rs. 30 per share will be called up in the event of winding up. The company is said to have reserve capital of Rs. 1,35,000 (4,500 × Rs. 30 per share). Reserve capital cannot be turned into ordinary capital without leave of the court, and it cannot be dealt with or charged by creditors.

SOME IMPORTANT MATTERS

1. PRIMARY EXPENSES:

These are expenses which are incurred in the initial stages of incorporation. Legal fees, remuneration of promoters, cost of preparing and printing of various documents, etc. are some of the costs incurred in promoting, organizing and preparing a company for operations. It is also known as 'Organization Cost'. Theoretically, organization costs benefit the company so long as it exists, and as such, it should not be written off. However, in practice, these costs are shown on the balance sheet as deferred charges and are written off over a period of 3 to 5 years.

2. RECORDS

Every company maintains proper records. In doing so, it has to maintain certain records, and maintaining of some other records is optional. Some of the records which must be maintained by a company are listed below:

1. Register of Members
2. Annual List of members and Summary
3. Register of Directors, managers, and Managing Agents
4. Minutes Book
5. Register of Mortgages
6. Proper books of account

There are other records also which a company would do well to maintain, that is, their maintenance is not required rather is helpful. Some of these records are:

1. Register of Documents
2. Share Certificate Book
3. Register of Transfer
4. Register of Share Warrants
5. Share Divident Book
6. Directors' Attendance Book
7. Agenda Book

3. UNDERWRITING COMMISSION:

In case a public company does not obtain an initial capital from the promoters, financers, it cannot proceed with the allotment of shares and also cannot get a certificate to commence business. The promoters of a company, therefore, make arrangements for underwriting with the sound parties. **"Underwriting" may be defined; as a contract made by the promoters with persons like brokers, or institutions like banks, insurance companies, syndicates or security dealers who are willing to take the whole or portion of such of the offered shares as may not be subscribed for by the public. The underwriters make the payment of subscribed shares in full to the company and sell them later on to the general public.** As the risk of the shares is transferred to the underwriters, they therefore, take the **"underwriting commission"** as agreed between the parties and also authorized by the Articles.

4. SHARE VALUES:

PAR VALUE:

This is the value assigned to a unit of share. This is arbitrarily determined. This value is authorized by the memorandum. It is also known as the nominal value or face value of the share.

BOOK VALUE:

It is the value of the shares according to the books of accounts of the company. If a company has issued only ordinary shares, the book value of an ordinary share is determined by dividing the total owners' equity by the number of shares issued (total owners' equity includes undistributed profits of past years). If

the company has issued different classes of shares the owners' equity has to be determined very carefully, keeping in mind the rights and privileges of each class of shares.

MARKET VALUE:

This is the value of a share as quoted on the stock exchange. The market value suggests the amount at which the buyer is willing to purchase and the seller is willing to sell a share. The market value is usually not the same as either the par value or the book value. Market value is influenced by anticipation of future profits and political and business conditions.

NOTE:

According to Companies Ordinance 1984, there is no classification of shares. There is only one type of shares which is called "Ordinary Shares" or "Equity Shares".

ISSUANCE OF SHARES

GENERAL PROCEDURE:

After completing the legal formalities described earlier, the company offers shares to the general public. Persons desirous of becoming shareholders of the company apply to the company for the purchase of a certain number of shares. This application is to be given on the prescribed form. These applications are given to banks approved by the company. Each application must be accompanied with the total amount of the value of shares applied for. After the last date of application has expired, the company gets information from all branches of approved banks about the total number of shares applied for and the total amount along with applications. This amount may be called the application money.

If the amount thus collected is equal or more than the amount of minimum subscription stated in the prospectus, the company proceeds to allot shares to the applicants. If share applications have been received in excess of the number of shares offered by the company, the issue is said to be over–subscribed and the oversubscribed amount is returned to the applicants.

The decision to allot shares is communicated to applicants by a letter known as the letter of allotment. These letters are signed by applicants and returned to the company on the basis of which the company prepares share certificates and these share certificates are sent to the applicants, who are now shareholders of the company.

ACCOUNTING FOR ISSUE OF SHARES – FIRST OR INITIAL ISSUE:

In the process of raising its minimum subscription, a company invites applications. When the minimum subscription has been raised, the company proceeds to allot the shares. An application for shares is an offer and the allotment is an acceptance. The allotment of shares is an act of the company by which an applicant for shares becomes the holder of the shares. Assume that Star Co. Ltd. has an authorized capital of Rs. 10,00,000 divided into 1,00,000 ordinary shares of Rs. 10 each. And that the minimum subscription stated in the memorandum is Rs. 4,00,000. Further assume that the company invites applications for 40,000 shares of Rs. 10 each (Rs. 4,00,000), requiring full payment of Rs. 10 per share applied for along with the application. Now, persons desirous of becoming shareholders of the company will fillin the application

forms and deposit money with banks (authorized by the company to collect). The money deposited will be equal to the number of shares applied for multiplied by the par value. A deadline is fixed for applications. After the close of that date each bank informs the company about the total amount of money collected by it on account of share applications.

Usually, the total collection will exceed Rs. 4,00,000, i.e. applications for more than 40,000 shares would have been received. In such cases the issue is said to be over–subscribed. If applications are received for less than 40,000 shares, the issue is said to be under–subscribed which is an exception. It seldom happens that applications for exactly 40,000 shares are received. In short, the total number of shares applied for may be (i) more than (a common featrue), (ii) less than (an exceptional case) or (iii) just equal (a rare situation) the number of shares offered by the company.

OVER–SUBSCRIPTION:

If the issue is over–subscribed, a certain formula is used to allot the shares. For example, applications for 10 shares may be alloted in full, applicants for 100 shares may be alloted 5 % of the shares applied for, and so forth. Thus the excess amount is returned to the applicants. After finalizing the allotment the company informs the banks (with whom the application money is lying) of the bases of refund, and the bankers refund the money accordingly.

ILLUSTRATION NO. 1

Yousaf Industries Ltd. was registered with an authorised capital of Rs. 20,00,000 divided into 200,000 ordinary shares of Rs. 10 each. The minimum subscription limited stated in the memorandum was Rs. 8,00,000. The company offered 80,000 shares of Rs. 10 each at par value. Record the above transactions in the books of the company and show how will it be shown in the Balance Sheet of company if:

(a) Applications for exactly 80,000 shares were received (a rare situation).

(b) Applications for 95000 shares were received (a case of over-subscription).

Solution:

(a) **JOURNAL**

Date	Details	Dr. Rs.	Cr. Rs.
	Bank Account	800,000	
	Ordinary Share Application A/c		800,000
	(Money received along with applications for 80,000 shares @ Rs. 10 each)		
	Ordinary Share Application A/c	800,000	
	Ordinary Share Capital A/c		800,000
	(Applicants alloted the shares as per Resolution No. _____)		

(b) **JOURNAL**

Date	Details	Dr. Rs.	Cr. Rs.
	Bank A/c	950,000	
	Ordinary Share Application A/c		950,000
	(Money received along with applications)		
	Ordinary Share Application A/c	800,000	
	Ordinary Share Capital A/c		800,000
	(80,000 shares alloted to the applicants)		
	Ordinary Share Application A/c	150,000	
	Bank A/c		150,000
	(Refund of applications money on 15000 shares)		

YOUSAF INDUSTRIES LTD.

Balance Sheet as at ....

Assets	Rs.	Share Capital & Liabilities	Rs.
Bank Balance	800,000	**Authorised Capital**	
		200,000 ordinary shares of	
		Rs. 10 each	20,00,000
		Issued & Subscribed Capital	
		80,000 Shares @ 10 each	800,000
	800,000		800,000

ILLUSTRATION NO. 2

(When there is undersubscription and deficiency is made up by the underwriters).

On May 1, 1992 Salman & Co. Ltd., offered 40,000 ordinary shares @ Rs. 10 each for public subscription. On May 3, 1992 (the closing date for applications) it is made known to the company that applications were received for 35000 shares. The 5000 shares not taken by the public are as per agreement, taken up by the underwriters. On May 20, 1992 the company alloted the shares. Pass the Journal entries and draft the Balance Sheet of the Company.

Solution:

JOURNAL

		Rs.	Rs.
1992			
May 3	Bank A/c	350,000	
	Ordinary Share Application A/c		350,000
	(Money received on applications)		
May 3	Bank A/c	50,000	
	Ordinary Share Capit.il A/c		50,000
	(5000 shares of Rs. 10 ea.:h taken up by underwriters as per agreement)		
May 20	Ordinary Share Application A/c	350000	
	Ordinary Share Capital A/c		350000
	(35000 shares alloted to public as per resulution No. ....)		

SALMAN & CO. LTD
Balance Sheet as at ......

Assets	Rs.	Share Capital & Liabilities	Rs.
Bank Balance	400,000	**Authorised Capital**	....
		Issued Capital	
		40,000 shares @ Rs. 10 each	400,000
		Subscribed Capital	
		35000 shares @ Rs. 10 each by public	350,000
		5000 shares @ Rs. 10 each by underwriters	50,000
	400,000		400,000

ILLUSTRATION NO. 3

(Shares taken by promotors against preliminary expenses)

A limited company was registered with an authorised capital of Rs. 10,00,000 divided into 100,000 shares of Rs. 10 each. On 1st August, 1993 15000 shares were issued to promoters in connection with their services and preliminary expenses paid by them. 50,000 shares were offered to the general public for subscription. Applications were received for 60,000 shares on the 10th August, 1993 the subscription date. On 25th August, 1993, shares were alloted to the applicants of 50,000 shares and the excess application money was refunded. Pass the journal entries and show how would they appear in the Balance Sheet.

Solution:

JOURNAL

		Rs.	Rs.
1993			
Aug. 1	Preliminary Expenses A/c	150,000	
	Ordinary Share Capital A/c		150,000
	(15000 shares taken by promoters)		
Aug. 10	Bank A/c	600,000	
	Ordinary Share Application A/c		600,000
	(Money received along with applications)		
Aug. 25	Ordinary Share Application A/c	500,000	
	Ordinary Share Capital A/c		500,000
	(50,000 shares alloted to applicants)		
Aug. 25	Ordinary Share Application A/c	100,000	
	Bank A/c		100,000
	(Application money refunded)		

BALANCE SHEET
as on ....

Assets	Rs.	Share Capital & Liabilities	Rs.
Bank Balance	500,000	**Authorised Capital**	
Preliminary Expenses	150,000	100,000 Shares @ Rs. 10 each	10,00,000
		Issued Capital	
		65000 shares @ Rs. 10 each	650,000
		Subscribed and paid up Capital	
		15000 shares taken by promoters	150,000
		50,000 shares taken by public	500,000
	650000		650000

ILLUSTRATION NO. 4

(Shares taken by the directors)

Dewan Corporation Limited was formed with an authorised capital of 20,000 shares of Rs. 50 each. 5000 shares were issued to the directors on 10th May, 1993 and 10,000 shares were offered to the public for subscription. The applications were received for only 8000 shares on 20th May, 1993. The shares were alloted to the applicants on 5th June, 1993. The remaining shares were taken up by the underwriters on 6th June, 1993 as per agreement. Pass the necessary journal entries in the books of the company.

Solution:

JOURNAL

		Rs.	Rs.
1993			
May 10	Bank A/c	250,000	
	Ordinary Share Capital A/c		250,000
	(5000 shares taken up by directors)		
May 20	Bank A/c	400,000	
	Ordinary Share Application A/c		400,000
	(Money received with applications)		
June 5	Ordinary Share Application A/c	400,000	
	Ordinary Share Capital A/c		400,000
	(8000 shares alloted to applicants)		
June 6	Bank A/c	100,000	
	Ordinary Share Capital A/c		100,000
	(2000 shares taken up by underwriters as per agreement)		

SUBSEQUENT ISSUE OF SHARES

Initial or first issue of shares is made by the company generally to raise its capital at least equal to the limit of minimum subscription in order to get certificate of commencement of business. After obtaining the certificate to commence business, a company is said to be in business. When companies are in the business, they often times issue more shares for various reasons. Such issues are referred to, here, as "Subsequent issues". Some of the reasons for which subsequent issues are made are as follows:

(a) To acquire more cash to increase its working capital.

(b) To acquire some fixed assets.

(c) To acquire a running business.

(d) To capitalize a portion of its undistributed profits.

Shares issued subsequently may be issued at par, at a premium, or at a discount.

ISSUE OF SHARES AT PREMIUM:

When a share having face value of Rs. 10 is issued by the company for an amount more than Rs. 10, the share is said to have been issued at a premium. The amount realised in excess of the par value is called premium on shares. Premium received (excess amount) on issue of shares should not be mixed up with the share capital of the company, rather it should be credited to a separate account called "premium on issue of shares". Undoubtedly, this is profit to the company but not the business profit. It is the capital profit of the company and is shown as a separate item on the liability side of the balance sheet.

An investor can only be willing to pay more than the par value of the shares if the company has a sound financial position and excellent future prospects of high earnings, or that the undistributed profits have increased the book value of the shares which is reflected in the higher market value of the shares.

Under Section 83 of the Companies Ordinance, 1984, this capital profit (premium on shares) can only be utilized by the company for the purposes mentioned below:

1. in writing off the preliminary expenses of the company;
2. in writing off the expenses of or the commission paid or discount allowed, on any issue of shares or debentures of the company;
3. in providing for the premium payable on the redemption of any redeemable preference shares or debentures of the company; or
4. in paying up unissued shares of the company to be issued to members of the company as fully paid bonus shares.

ILLUSTRATION NO. 5

On 1st July, 1992 Noor Chemicals Ltd. was formed with an authorised capital of 500,000 shares of Rs. 10 each. The subscribed and paid up capital of the company was 300,000 shares of Rs. 10 each. On 1st Nov., 1992, the management of the company decided to issue 100,000 shares at a

premium of Rs. 2 per share as subsequent issue. Applications were received for 120,000 shares. Shares were alloted and money was refunded for applicants of 20,000 shares.

Pass the necessary journal entries and draft the Balance Sheet of the company.

Solution:

JOURNAL

Date	Details	Dr. Rs.	Cr. Rs.
	Bank A/c	14,40,000	
	Ordinary Share Application A/c		14,40,000
	(Money received with applications)		
	Ordinary Share Application A/c	12,00,000	
	Ordinary Share Capital A/c		10,00,000
	Premium on Issue of Shares A/c		200,000
	(Share alloted at a premium of Rs. 2)		
	Ordinary Share Application A/c	240,000	
	Bank A/c		240,000
	(Money refunded)		

NOOR CHEMICALS LTD.
Balance Sheet as at ....

Assets	Rs.	Share Capital & Liabilities	Rs.
Sundry Assets	30,00,000	**Authorised Capital**	
		500,000 shares of Rs. 10 each	50,00,000
Bank Balance	1200,000	**Issued, Subscribed & paid up Capital**	
		400,000 shares of Rs. 10 each	40,00,000
		Premium on issue of shares	200,000
	4200,000		4200,000

ISSUE OF SHARES AT A DISCOUNT

If a share of Rs. 10 is issued for an amount less than Rs. 10 the share is said to have been issued at a discount. The difference between the amount received and the par value of the share represents the discount which should be recorded in a separate account named "Discount on issue of shares". An investor may not be willing to pay the par value of the share because the company has a poor financial position as compared with its competitors, or that it has failed to distribute profit in the past years which is reflected in a lower market value of the shares.

There are certain legal restrictions on the issue of shares at a discount. A company desiring to issue shares at a discount has to pass a resolution in a general meeting and obtain confirmation of the court. Only that class of share can be issued at a discount which has already been issued. Shares cannot be issued at a discount for at least a year since the company became entitled to commence business. The discount should not exceed 10 per cent of the par value of shares. If approved by the court, such shares must be issued within sixty days of the date on which the issue is sanctioned by the authority. In the discussion to follow, whenever issuance of shares at a discount is involved, it is assumed that the legal requirements have been met.

ILLUSTRATION NO. 6

Asif Ltd. with an authorised capital of 100,000 shares of Rs. 10 passed a resolution in a general meeting to issue 40,000 shares at a discount of 5 %. 10,000 shares were issued to directors and 30,000 shares were offered to general public. Applications were received for 25000 shares and subsequently shares were alloted. Record the transactions in the books of the company and show the reflection in the Balance Sheet.

Solution:

JOURNAL

		Rs.	Rs.
	Bank A/c	95000	
	Discount on Issue of Shares A/c	5000	
	Ordinary Share Capital A/c		100,000
	(10000 shares issued & alloted to directors at 5 % discount)		
	Bank A/c	237500	
	Ordinary Share Application A/c		237500
	(Money received with applications for 25000 shares)		
	Ordinary Share Application A/c	237500	
	Discount on Issue of Shares A/c	12500	
	Ordinary Share Capital A/c		250,000
	(Shares alloted to the public)		

ASIF LTD.
Balance Sheet as at ....

Assets	Rs.	Share Capital & Liabilities	Rs.
Bank Balance	332500	**Authorised Capital**	
		100,000 shares @ 10 each	1000,000
Discount on issue of shares	17500	**Issued Capital**	
		40,000 shares @ 10 each	400,000
		Subscribed & Paid up Capital	
		35000 shares @ 10 each	350,000
	350,000		350,000

NOTE:

Discount on issue of share is a fictitious asset and is shown on the asset side of Balance Sheet until it is written off.

ISSUE OF SHARES IN CONSIDERATION OF ASSETS OTHER THAN CASH:

So far the discussion was confined to the issuance of shares for cash. There are situations where shares may be allotted not against cash payments but for consideration other than cash. Sometimes a company takes over a property or a running business. A contract is signed between the (acquiring) company and the vendor. The amount involved is known as the purchase consideration. This purchase consideration may be paid by the acquiring company in fully paid up shares.

For example, at the time a company is being set up, it may acquire a running business or property like building, machinery, etc. In payment for such acquisitions, the company may allot fully paid up shares to the vendors of the business or property. When such an exchange is made, it is necessary to know the current selling price of the share or the fair market value of the assets acquired. The exchange will take place only when both the parties, the buyer (company) and the seller, are convinced that the value of the things being exchanged (shares and properties) is the same. The current selling price of an initial issue of shares is the par value of the share. Assume that Bashir & Co. acquired a building, a plot of land, and machinery from Dawar Brothers at a fair market value of Rs. 60,000; Rs. 40,000; and Rs. 30,000, respectively. Bashir & Co. issued 13,000 shares of Rs. 10 each in payment of the purchase consideration. And Dawar Brothers agreed to this dealing.

Remember, this exchange will take place only when the buying company, Bashir & Co., are interested in those properties; and the vendor, Dawar Brothers, is interested in shares of Bashir & Co. Secondly, this exchange will take place only when Bashir & Co. is satisfied that the fair market value of the

properties is Rs. 1,30,000; and Dawar Brothers, the vendor, is satisfied that the current market price of the 13,000 shares is Rs. 1,30,000. Otherwise, the exchange will not take place. Thus, the following journal entries are made on the books of the Bashir & Co.

	Rs.	
Building A/c	60,000	
Land A/c	40,000	
Machinery A/c	30,000	
Dawar Bros. A/c		130,000
Acquisition of assets as per agreement		
Dawar Bros. A/c	130,000	
Ordinary Share Capital A/c		130,000
13000 shares of Rs. 10 each alloted to vendor in payment of purchase consideration		

ILLUSTRATION NO. 7

Zaheer Co. Ltd. acquires land worth Rs. 400,000, building Rs. 500,000 and machinery worth Rs. 100,000 from Mr. Hayat and offers to pay him Rs. 250,000 in cash and the balance in fully paid up shares of Rs. 10 each at a premium of Rs. 2.50. Mr. Hayat accepts this offer.

Pass the journal entries in books of the company.

Solution:

JOURNAL

Date.	Details	Dr. Rs.	Cr. Rs.
	Land A/c	400,000	
	Building A/c	500,000	
	Machinery A/c	100,000	
	Mr. Hayat (Vendor)		10,00,000
	Assets acquired from vendor		
	Mr. Hayat A/c	10,00,000	
	Cash/Bank A/c		250,000
	Ordinary Share Capital A/c		600,000
	Share Premium A/c		150,000
	Cash paid and 60,000 shares alloted at premium		

ACQUISITION OF A RUNNING BUSINESS:

Sometimes a company buys up a running business and pays the vendor in shares of the company, or partly in cash and partly in shares. Assume that Sarfraz & Co. Ltd. acquires the partnership business of Zulfiqar Bros. The agreed value of assets and liabilities acquired by Sarfraz & Co. Ltd. is as follows:

Assets:	
Stock of goods	Rs. 30,000
Building	130,000
Machinery	240,000
Goodwill	80,000
	480,000
Liabilities:	
Bank Loan	180,000
Net assets taken over	Rs. 300,000

Assume that both the parties have agreed to settle the purchase consideration in the form of shares of Sarfraz & Co. Ltd., and that the par value of each shares is Rs. 10. The three possibilities may be as follows:

(i) Sarfraz & Co. Ltd. may issue shares whose total par value will be just equal to the value of net assets taken over, that is 30,000 shares of Rs. 10 each. This arrangement means that the shares are issued at par.

(ii) Sarfraz & Co. Ltd. may issue shares whose total par value will be less than the value of net assets taken over, say, 26000 shares of Rs. 10 each. This suggests that the current market value of 26000 shares is not 260,000 but is equal to Rs. 300,000. This arrangement means that the shares are issued at a premium.

(iii) Sarfraz & Co. Ltd. may issue shares whose total par value will be more than the value of assets taken over, say, 32000 shares of Rs. 10 each. This suggests that the current market value of 32000 shares is not Rs. 320,000 but is equal to Rs. 300,000. This arrangement means that the shares are issued at a discount.

Journal entries under each of these situation are given below:

(1) AT PAR:

JOURNAL

		Rs.	Rs.
	Stock A/c	30,000	
	Building A/c	130,000	
	Machinery A/c	240,000	
	Goodwill A/c	80,000	
	Bank Loan A/c		180,000
	Zulfiqar Bros. A/c		300,000
	Assets & Liabilities taken over for a purchase consideration of Rs. 300,000		
	Zulfiqar Bros. A/c	300,000	
	Ordinary Share Capital A/c		300,000
	30,000 shares alloted at Rs. 10 (par value) in full settlement of purchase consideration		

(2) AT PREMIUM:

		Rs.	Rs.
	First entry is the same		
	Zulfiqar Bros. A/c	300,000	
	Ordinary Share Capital A/c		260,000
	Premium on Shares A/c		40,000
	26000 shares of Rs. 10 each issued at premium in full settlement of purchase consideration		

(3) AT DISCOUNT:

		Rs.	Rs.
	First entry is the same		
	Zulfiqar Bros. A/c	300,000	
	Discount on Shares A/c	20,000	
	Ordinary Share Capital A/c		320,000
	32000 shares of Rs. 10 each issued at a discount, in full settlement of purchase consideration		

ILLUSTRATION NO. 8

A limited company acquired the business of Rizwan Bros., whose assets and liabilities are given below:

Assets	*Rs.*	*Liabilities*	*Rs.*
Land	**15000**	**Sundry creditors**	**10,000**
Plant & Machinery	**69000**	**Bank Loan**	**5000**
Bills Receivable	**11000**	**Bills payable**	**5000**
Sundry debtors	**19000**	**Capital Profit**	**4000**
Furniture	**24000**		

It is agreed that the company will acquire the assets and liabilities at book value and will pay the purchase consideration, 30000 in cash and the balance in fully paid up shares of Rs. 10 each at par value.

Pass the required entries in the books of the company.

Solution:

JOURNAL

		Rs.	Rs.
	Land A/c	15000	
	Plant & Machinery A/c	69000	
	Bills Receivable A/c	11000	
	Sundry Debtors A/c	19000	
	Furniture A/c	24000	
	Sundry Creditors A/c		10,000
	Bank Loan A/c		5000
	Bills Payable A/c		5000
	Capital Profit A/c		4000
	Rizwan Bros. (vendor)		114000
	Assets & Liabilities taken over		
	Rizwan Bros. A/c	114000	
	Cash A/c		30,000
	Ordinary Share Capital A/c		84000
	Paid the vendor cash and 8400 shares of Rs. 10 each		

ILLUSTRATION NO. 9

Wasim Corporation Ltd. agreed to take over the business of M/s Waqar & Sons. The assets and liabilities of M/s Waqar & Sons are shown below:

Land and Building	**Rs. 100,000**	**Creditors**	**Rs. 15000**
Plant & Machinery	**Rs. 80,000**	**Bank Loan**	**Rs. 10,000**
Furniture	**Rs. 40,000**		
Debtors	**Rs. 35000**		

The purchase consideration is settled by fully paid up shares of Rs. 10 each at par value. Pass the journal entries:

(a) if purchase consideration is determined at book value.

(b) if purchase consideration is Rs. 250,000.

(c) if purchase consideration is Rs. 210,000.

Solution:

(a)

		Rs.	Rs.
	Land & Machinery A/c	100,000	
	Plant & Machinery A/c	80,000	
	Furniture A/c	40,000	
	Debtors A/c	35000	
	Creditors A/c		15000
	Bank Loan A/c		10,000
	M/s Waqar & Sons		230,000
	Assets & Liabilities acquired at book value.		
	M/s Waqar & Sons	230,000	
	Ordinary Share Capital A/c		230,000
	23000 shares alloted to vendor in full satisfaction of purchase consideration		

(b)

		Rs.	Rs.
	Land & Building A/c	100,000	
	Plant & Machinery A/c	80,000	
	Furniture A/c	40,000	
	Debtors A/c	35000	
	Goodwill A/c	20,000	
	Creditors A/c		15000
	Bank Loan A/c		10,000
	M/s Waqar & Sons		250,000
	Assets & Liabilities acquired		
	M/s Waqar & Sons	250,000	
	Ordinary Share Capital A/c		250,000
	25000 shares alloted to discharge purchased consideration		

NOTE:

If the total of liabilities taken over and purchase consideration (25000 + 250,000) exceeds the assets taken over (255000), the difference is considered as goodwill. In the same way, if the total of assets taken over exceeds the total of liabilities and purchase consideration, the difference is credited to capital profit A/c as is shown below:

(c)

		Rs.	Rs.
	Land & Building A/c	100,000	
	Plant & Machinery A/c	80,000	
	Furniture A/c	40,000	
	Debtors A/c	35000	
	Creditors A/c		15000
	Bank Loan A/c		10,000
	M/s Waqar & Sons		210,000
	Capital Profit A/c		10,000
	Assets & Liabilities acquired		
	M/s Waqar & Sons	210,000	
	Ordinary Share Capital A/c		210,000
	21000 shares of Rs. 10 each alloted in discharge of purchase consideration		

ACCOUNTING FOR DEBENTURES

What debentures are?

Every trading company has an implied power to borrow money for the purposes of its business. One of the many methods of borrowing is that of issuing of debentures. In general, a debenture is a document evidencing indebtedness of the company. This instrument (debenture) is issued for long–term borrowing. The usual way in which a company borrows money is by issuing debentures. Debentures are also termed as "Bonds". These are issued under the seal of the company containing a contract for the repayment of the principal amount at a specified date and for the payment of interest at a fixed rate until the principal amount is repaid.

KINDS OF DEBENTUR:

The following are the various kinds of debentures that may be issued by a company:

Redeemable Debentures are those which are repayable at the end of a specified period.

Irredeemable Debentures are such as are never repayable during the existence of the company. These are generally issued by Railway and such other companies.

Simple or Naked Debentures are those which carry no security as to payment of interest or repayment of principal.

Registered Debentures are debentures registered in the name of the holders in the books of the company, and the transfers of these must be registered in the books of the company as in the case of shares.

Bearer Debentures are payable to bearer. They are negotiable instruments and are transferable by mere delivery.

Mortgage Debentures are those which are secured by a fixed or floating charge on the assets of the company. In case of a fixed charge, an actual mortgage deed is entered into between the company on the one hand and the trustees on behalf of the debenture–holders on the other, whereby some fixed assets of the company such as Building, Plant and Machinery, etc., are specifically mortgaged. In case of a floating charge, the company merely agrees that, in case of failure as to payment of interest or principal, the debenture–holders will have a prior claim to such asset as would then belong to the company.

Debenture Stock is one or more series of debentures consolidated, each stock–holder being entitled to such proportion of the whole amount as is represented by his stock certificate. The stock is more readily transferable than is the case with debentures.

DIFFERENCE BETWEEN A SHAREHOLDER AND A DEBENTUREHOLDER:

The following are the fundamental differences between a Shareholder and a Debentureholder:

(a) A shareholder is a partner in the company, whereas a debentureholder is a loan creditor of the company.

(b) A shareholder is entitled only to a dividend on his shares, when there are sufficient profits to enable the declaration of such dividend and provided that the dividend is sanctioned by the general meeting. A debentureholder is entitled to his agreed interest irrespective of the fact whether the company has made profit or loss. The interest on debentures is, therefore, a charge against profits, whereas any dividend in respect of shares is an appropriation of profits.

(c) Shareholders can extend a controlling hand in the management of the company by voting at general meetings, but the debenture–holders have no right of interference in the management of the company so long as the terms of the debentures are complied with.

(d) When a company is wound up, a debentureholder, even if unsecured, will always rank for repayment in full before the shareholders of any class.

IMPORTANT DETAILS RELATING TO DEBENTURES:

Every debenture has coupons for interest attached to it. The coupon is an order on the company's bank to pay a certain sum to the person who presents it on or after a certain date. The interest is payable to the bearer of the coupon. These coupons are always transferable. Interest is paid periodically, generally half–yearly. The date on which the interest is due is called interest date.

The instrument called the debenture usually consists of two parts – (i) the body, containing the bond and the charge, and (ii) the conditions indorsed thereon. The conditions endorsed on the debenture are:

(i) that the debenture is one of a series of a certain limited number;

(ii) that the principal amount is the same as of others in series;

(iii) that all the debentures of the series rank pari passu (pari passu means that all the debentures of the series are to be paid rateably);

(iv) that the debentures have a first or other charge;

(v) and conditions regarding:

  (a) registration,

  (b) transfer, and

  (c) mode of repayment of the principal moneys.

A common form of securing debentures is to execute a deed of trust. Where a debenture is accompanied by a trust deed, many of the conditions endorsed on the debenture are embodied in the trust deed. Trust deeds have the following advantages:

(i) If the company makes a default, the trustees are there to take necessary steps, instead of leaving it to the initiative of some debentureholders.

(ii) The trustees may be given the power to sell the security, if any without the aid of the court.

(iii) The company may be made to insure, etc., by the terms of the deed.

The period of debentures may be (i) for a fixed number of year, (ii) payable on demand, or (iii) perpetual (that is, no time is fixed within which the company would be bound to redeem them). All debentures, irrespective of their kind, become immediately payable on the company going into liquidation.

While issuing debenture, certain costs are incurred. For example, fee paid to attorneys for legal advice is connection with the issue, fee paid to accountants and other experts in connection with the preparation of a prospectus or registration statement, commission paid to underwriters or brokers for placing the issue, printing and engraving costs, and the like. These amounts are paid for services, the benefits from which flow, normally, over the whole period of the debenture. Such costs are better termed debenture issue costs. Accordingly, issue costs should be treated as assets, and written off (amortized) like other prepayments. Debenture issue costs should not be adjusted with debenture discount or premium.

ISSUE OF DEBENTURES

The entries for issue of debentures are very similar as the issue of shares. Generally debentures are issued at lump sum basis and they are issued "at par" "at Premium" or at a discount". Similarly they may be redeemed at par or at premium. We have seen that shares may be issued at par, at discount or at premium and no question arises regarding the redemption of shares. But in case of debentures, we have to consider the conditions of redemption of debentures while passing the entries.

There are five conditions under which debentures are issued and redeemed. These conditions along with journal entries have been discussed below:

NOTE:

If condition for redemption (regarding price at which debenture is to be redeemed) is not mentioned, it is implied that it would be redeemable at par.

1. DEBENTURES ISSUED AT PAR AND REDEEMABLE AT PAR:

In this case at the time of issue of debentures, the asset bank balance is increased and a liability (Debenture A/c) also increases with equal amount. Thus at the time of issue of debenture, the following entry will be passed:

Bank A/c	Dr.	x x x	
% Debenture A/c			x x x

Suppose Zeeshan Ltd. issued 100 8 % debentures of Rs. 1000 each repayable at par after 10 years:

(i)	Bank A/c	Dr.	100,000	
	8 % Debenture A/c			100,000
	Being issue of 100 debentures @ Rs. 100 at par.			

(ii) At the time of repayment of these debentures after 10 years the following entry will be made:

8 % debentures A/c	Dr.	100,000	
Bank A/c			100,000
Being repayment of 100 debentures of Rs. 1000 each.			

2. ISSUE OF DEBENTURES AT DISCOUNT AND REDEEMABLE AT PAR:

Debentures can be issued at discount unless the articles restrict such an issue. It is issued when the rate of interest is low and the Co. persuades prospective investors to invest their savings in the purchase of such debentures. In such case the Co. receives a smaller amount with the face value of the debenture. The difference between the face value and the amount received is treated as discount on issue of debentures. It is a capital loss and will appear on the balance sheet of the Co. on the assets side.

Suppose on June 1, a company issued 1000 8 % debentures of Rs. 100 each repayable after 10 years at Rs. 95. The following entries are passed:

(i) at the time of issue:

Bank A/c	Dr. 95000	
Discount on issue of debentures	5000	
8 % Debenture A/c		100,000
Being issue of 1000 8 % debentures of Rs. 100 each at Rs. 95		

(ii) at the time of redemption:

8 % Debentures A/c	Dr. 100,000	
Bank A/c		100,000
Being repayment of 1000 8 % debentures of Rs. 100 each		

NOTE:

Discount on issue of debenture is a fictitious asset and is shown on the asset side of Balance Sheet until it is written off.

3. ISSUE OF DEBENTURES AT PREMIUM AND REDEEMABLE AT PAR:

When debenture/bonds are issued at a premium, such a premium should be credited, to a debenture premium account, this premium is a profit earned outside the usual course of the business, and it is advisable that it should not be treated as a profit distributed to share– holders as dividend. The proper treatment would be to utilize it in writing off expenses of issue of debentures, or writing off any other fictitious assets like, Goodwill, Preliminary Expenses etc. It is shown on the liability side of Balance Sheet until it is utilised.

Suppose a company issued 1000 6 % debentures of Rs. 100 each at Rs. 105 repayable after 5 years. The following entries are passed:

(i) at the time of issue:

Bank A/c	Dr. 105000	
5 % Debenture A/c		100,000
Premium on issue of debenture A/c		5000
Being issue of 1000 6 % debentures at premium		

(ii) at the time of redemption:

6 % Debentures A/c	Dr.	100,000	
Bank A/c			100,000
Being redemption of debentures at par			

ISSUE OF DEBENTURES AT PAR AND REDEEMABLE AT PREMIUM:

In this case the company issues the debentures at par value but agrees to pay the debentureholder more than the par value at the time of redemption. The excess amount payable by the company is premium on redemption of debentures and is a liability. This premium is different from premium on issue of debentures which is capital profit of the company. But this liability will occur at the time of redemption. It is a general practice in Pakistan to recognise this loss at the time of issue of debentures.

Suppose a company issued 1000 8 % debentures of Rs. 100 each at Rs. 100 but redeemable at Rs. 105 after 5 years. The following entries are to be passed:

(i) At the time of issue:

Bank A/c	Dr.	100,000	
Loss on issue of debentures A/c	Dr.	5000	
8 % Debentures A/c			100,000
Premium on Red. of Debenture A/c			5000
Being issue of 1000 8 % debentures of Rs. 100 redeemable at Rs. 105			

The premium on redemption of debenture is shown on the Balance Sheet till the date of redemption. The loss on issue of debenture will be amortized in the life period of debentures. On the date of maturity, the debenture amount and the premium on redemption of debenture will be transferred to debenture holders account, and a transfer entry is to be made in books of account as:

(ii) At the time of redeemption:

(a)

8 % Debenture A/c	Dr.	100,000	
Premium Red. of debenture	Dr.	5000	
Debentureholder A/c			10500

(b) On payment to debentureholder:

Debentureholder A/c	Dr.	105000	
Bank A/c			105000

5. ISSUE OF DEBENTURES AT DISCOUNT AND REDEEMABLE AT PREMIUM:

If debentures are issued at discount and are redeemable at premium, it is a double edged loss to the company.

Suppose a company issued 1000 8 % debentures of Rs. 100 each at Rs. 95 redeemable at Rs. 105. Following entries are to be passed:

(i) At the time of issue:

Bank A/c	Dr.	95000	
Loss on issue of debentures	Dr.	10,000	
8 % Debenture A/c			100,000
Premium on Red. of Deb.			5000
Being issue of 1000 8 % debentures at Rs. 95 redeemable at Rs. 105			

(ii) At the time of redemption:

8 % Debentures A/c	Dr.	100,000	
Premium on Red. of Debentures	Dr.	5000	
Bank A/c			105000

In this case the loss represents the difference between the discount and par value and also the par value and the premium value. The whole of this loss will be spread over equally over the life of debentures and proportinately amortized.

ILLUSTRATION NO. 10

Excellent Co. Ltd. issued 10,000 8 % Debentures of Rs. 100 each. Give journal entries if the debentures are (a) issued at par, (b) issued at 10 % discount and
(c) issued at a premium of 10 % (redemption being in all these cases at par).

Also show the entries which will be made if the debentures are redeemable at a premium of 5 % but are issued (i) at par, and (b) at a discount of 10 %.

In each case show how the figures will appear in the Balance Sheet.

Solution:

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Debentures Redeemable at Par

			Rs.	Rs.
	(a) Issued At Par:			
	Bank Account	Dr.	10,00,000	
	8 % Debentures Account			10,00,000
	Being issue of 10,000 debentures at Rs. 100 each			
	(b) Issued At 10 % Discount:			
	Bank Account	Dr.	900,000	
	Discount on Issue of Debentures Account Dr.		100,000	
	8 % Debentures Account			10,00,000
	Being issue of 10,000 debentures at Rs. 90 each			
	Issued at 10 % Premium			
	Bank Account	Dr.	11,00,000	
	8 % Debentures Account			10,00,000
	Premium on issue of Debenture Account			100,000
	Being issue of 10,000 debentures at Rs. 110			

DEBENTURES REDEEMABLE AT A PREMIUM OF 5 %

			Rs.	Rs.
	(i) Issued At Par:			
	Bank Account	Dr.	10,00,000	
	Loss on Issue of Debentures Account	Dr.	50,000	
	6 % Debentures			10,00,000
	Premium on Redemption of Debentures Account			50,000
	(Being the issue of 10,000 6 % Debentures of Rs. 100 each (redeemable at Rs. 105) issued at par)			
	(ii) Issued At a Discount of 10 %:			
	Bank Account	Dr.	900,000	
	Loss on Issue of Debentures Account	Dr.	1,50,000	
	6 % Debentures			10,00,000
	Premium on Redemption of Debentures Account			50,000
	(Being the issue of 10,000 6 % Debentures of Rs. 100 @ Rs. 90 each repayable at Rs. 105 per debenture)			

BALANCE SHEET OF EXCELLENT CO. LTD.

Debenture Redeemable at Par:

Assets	Rs.	Liabilities	Rs.
		(1) Issued at Par:	
Cash at Bank	10,00,000	6 % Debentures	10,00,000
Cash at Bank	9,00,000	**(2) Issued at a discount of 10 %:**	
Discount on Debentures	1,00,000	6 % Debentures	10,00,000
	10,00,000		10,00,000
		(3) Issued at a premium of 10 %:	
Cash at Bank	11,00,000	6 % Debentures	10,00,000
		Premium on Redemption	1,00,000
	11,00,000		11,00,000

BALANCE SHEET (Contd.)

Debenture Redeemable at a premium of 5 %:

Assets	Rs.	Liabilities	Rs.
		(1) Issued at Par:	
Cash at Bank	10,00,000	6 % Debentures	10,00,000
Loss on Issue of Debentures	50,000	Premium on Redemption of Debentures	50,000
	10,50,000		10,50,000
		(2) Issued at a discount of 10 %:	
Cash at Bank	9,00,000	6 % Debentures	10,00,000
Loss on Issue of Debentures	1,50,000	Premium on Redemption of Debentures	50,000
	10,50,000		10,50,000

ILLUSTRATION NO. 11

Faisal Industries Ltd. acquired the business of Naeem Bros. for a purchase consideration of Rs. 770,000. The book value of the assets were Rs. 760,000 and those of liabilities Rs. 30,000. The company issued debentures of Rs. 100 each to Naeem Bros. Pass the journal entries in the books of the company if:

(a) debentures were issued at par value.

(b) debentures were issued at 10 % discount.

(c) debentures were issued at 10 % premium.

Solution:

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Date	Details		Dr. Rs.	Cr. Rs.
	Sundry Assets A/c	Dr.	760,000	
	Goodwill A/c	Dr.	40,000	
	Sundry Liabilities A/c			30,000
	Naeem Bros. A/c			770,000
	Assets & Liabilities taken over			
(a)	Naeem Bros.	Dr.	770,000	
	Debentures A/c			770,000
	7700 debentures issued at par			
(b)	Naeem Bros. A/c	Dr.	770,000	
	Discount on Issue of Debentures	Dr.	85550	
	Debentures A/c			855500
	Cash A/c			50
	Being issue of 8555 debentures and fraction is paid in cash			
(c)	Naeem Bros.	Dr.	770,000	
	Debentures A/c			700,000
	Premium on Issue of Debenture A/c			70000
	Being issue of 7000 debentures at 10 % premium			

QUESTIONS

1. Define a Joint Stock Company and state its essential characteristics.
2. Define a company. What is the procedure for its formation?
3. What are the kinds of companies? Discuss briefly.
4. What is memorandum of association and what details it must contain?
5. What documents are to be filed with the registrar of companies for obtaining a certificate of incorporation?
6. Explain the followings:
   (a) Preliminary Expenses (b) Underwriting commission
   (c) Face value (d) Market value.
7. What is the general procedure for the issuance of shares?
8. How premium on shares can be utilised under the legal provisions of Companies Ordinance?
9. Under what conditions a company can issue its shares at discount and what is the accounting treatment for discount on shares?
10. Define debenture. How a debentureholder is distinguished from a shareholder?
11. What are the different kinds of debentures?
12. Under what conditions debentures are issued and redeemed?

PROBLEMS

1. Sohail Ltd. was registered with an authorised capital of Rs. 40,00,000 divided into 400,000 ordinary shares of Rs. 10 each. The company issued 200,000 ordinary shares to general public for subscription at par value on 1st July 1992. Subscription date was fixed as 15th July. Pass the entries in the books of the company if:

   (a) Applications for 200,000 shares were received.

   (b) Applications for 230,000 shares were received.

   Shares were alloted on 31st July, 1992.

   Also show how the figures would appear in the balance sheet of the company.

2. On June 1, 1993 Decent Ltd. issued 50,000 ordinary shares @ Rs. 10 each. Out of these 50,000 shares, 10,000 shares were issued to directors and remaining to the general public. On 15th June (the subscription date) applications were received for 35000 shares. Consequently 5000 shares were taken up by the underwriters as per agreement. On 30th June, 1993 the company alloted the shares.

   Pass the journal entries in the books of the company and draft a balance sheet.

3. A Limited Company was registered with an authorised capital of Rs. 500,000 divided into 10,000 shares of Rs. 50 each. On 1st Nov., 1994 company issued 7000 shares in the following manner:

   1000 shares to promoters against Preliminary Expenses.

   2000 shares to directors for cash.

   4000 shares to general public.

   On 15th November, 1994, company received applications for 6000 shares. Shares were not alloted to applicants of 2000 shares and their application money was refunded.

   Record the above information in company's books and show the figures in the Balance Sheet.

4. A Trading Corporation was formed with an authorised capital of 50,000 ordinary shares of Rs. 1000 each. On 1st Jan., 1994, the company issued 30,000 shares to the general public and 5000 shares were issued to a vendor, Mr. Asghar from whom company had acquired machinery worth Rs. 500,000. Applications were received on 10th Jan. 1994 only for 25000 shares and consequently 5000 shares were taken up by the underwriters. On 20th Jan., 1994 shares were alloted to the applicants.

   Pass the journal entries in the books of the company and show the Balance Sheet.

5. On 15th August, 1995 a company was registered with an authorised capital of 100,000 shares of Rs. 10 each. On 1st Jan., 1996, the subscribed and paid up capital of the company was 50,000 shares of Rs. 10 each. On 15th Jan., the company issued 20,000 shares of Rs. 10 each to general public at 10 % premium. Applications were received for 35000 shares. On 30th Jan., shares were alloted and money was refunded to the applicants of 15000 shares.

   Record the above transactions in the books of the company and draft the Balance Sheet.

6. Asif Bashir Ltd. with an authorised capital of Rs. 100,0000 divided into 100,000 shares of Rs. 10 each and subscribed and paid up capital of 50,000 shares of Rs. 10 each, passed a resolution in a general meeting to issue 20,000 shares of Rs. 10 each at 10 % discount. The issue was permitted by the authorities. Applications were received for 15000 shares. Shares were alloted.

   Make the necessary entries and prepare the Balance Sheet.

7. Imran Textiles Ltd. acquired the business of M/s Noor & Sons. The assets and liabilities of M/s Noor & Sons at book value are given below:

Land & Building	50,000	Sundry Creditors	10,000
Machinery	40,000		
Furniture	15000		
Debtors	5000		

   The purchase consideration is to be paid by the company in fully paid up shares of Rs. 10 each. Pass the journal entries if the shares are issued:

   (a) At Par (b) At 10 % Discount (c) At 10 % Premium.

8. A Ltd. Company issued 10,000 12 % debentures of Rs. 100 each. What entries will be made if:

   (a) debentures are issued at par value.

   (b) debentures are issued at 5 % premium.

   (c) debentures are issued at 10 % discount.

9. Ali Industries Ltd. issued 5000 10 % debentures of Rs. 1000 each. What entries will be passed if:

   1. Debentures are issued at par and redeemable at par.
   2. Debentures are issued at 7 % discount and redeemable at par.
   3. Debentures are issued at 8 % premium and repayable at par.
   4. Debentures are issued at par and redeemable at 4 % premium.
   5. Debentures are issued at 5 % discount and redeemable at 4 % premium.

10. Haider Ltd. acquired the assets and liabilities of Mr. Rashid valued at Rs. 500,000 and 40,000 respectively. It was agreed that the purchase consideration would be settled by issue of 8 % debentures of Rs. 100 each by Haider Ltd. Pass the entries if the purchase consideration was (a) Rs. 460,000, (b) Rs. 480,000 and (c) Rs. 430,000.

CHAPTER - 22

DEPRECIATION, PROVISIONS AND RESERVES

DEPRECIATION, PROVISIONS AND RESERVES

Depreciation is the reduction in value of an asset as a result of fair wear and tear. As an asset loses its value/efficiency we reduce the book valuation of it in line with our estimate of loss. Depreciation is a fairly complex topic, where book–keeping merges into Accountancy. The Accounting principle which motivates Accountants to try different methods of depreciation. is that we are seeking in our Accounting to achieve a 'true and fair view' of the position of the business. This 'true and fair view' requires two things:

(1) The assets must be valued on the books at a fair value so far as we can estimate it.

(2) If a loss has been suffered it must be charged against the profits to do otherwise would overstate the profitability of the business. Apply these two rules to the problem of depreciation, we see that if an asset wears out the loss suffered as a result of wear and tear must be written off the profits. At the same time the assets will be reduced in value to show only its present value now that it has been partly worn out.

DIFFERENT AUTHORS HAVE GIVEN DIFFERENT DEFINITIONS OF DEPRECIATION, SUCH AS:

"Depreciation is the gradual decrease in the efficiency of an asset expressed in monetary terms because of its usage and wear and tear".

– By the Author of the Book

"Depreciation may be defined as the permanent and continuous diminution in the quality, quantity or value of an asset".

– Pickles

"Depreciation is the gradual and permanent decrease in the value of an asset from any cause".

– Carter

"Depreciation may be defined as a measure of the exhaustion of the effective life of an asset from any cause during a given period".

– Spicer & Pegler

"Depreciation is the diminution in intrinsic value of asset due to use and/or the lapse of time".

– Terminology of the Institute of Cost & Management Accountants, England

"Depreciation is the reduction in value of a fixed asset occasioned by physical wear and tear, obsolescence or the passage of time".

– Northcott & Forsyth

From the above definitions it follows that an asset gradually declines on Account of use and passage of time and this causes permanent reduction in the value and utility of asset. Such reduction in the value or utility of asset is called depreciation. In other words, expired cost or utility of asset is depreciation.

CAUSES OF DEPRECIATION

Depreciation may be of two types:

(1) INTERNAL:

Depreciation which occurs for certain inherent normal causes, is known as internal depreciation. The causes of internal depreciation are:

(a) Wear and Tear:

An asset declines on Account of continued use, e.g. Building, Plant, Machinery etc. Such decline depends on the quantum of use of the asset. If a factory works double–shift instead of single–shift, depreciation on plant and machinery will be doubled. It is obvious that such loss is unavoidable. An asset may be kept in proper working condition through repairs for the time being, but it cannot be done, so permanently. At one time the asset will become unfit for repairs, when it will no longer be usable.

(b) Depletion:

Some asset declines in value proportionate to the quantum of production, e.g. Mine, Quarry etc. With the raising of coal from coalmine the total deposit reduces gradually and after sometime it will be fully exhausted. Then its value will be reduced to nil.

(2) EXTERNAL:

Depreciation caused by some external reasons is called external depreciation. The causes of external depreciation are:

(a) Obsolescence:

Some assets, although in proper working order, may become obsolete. For example, old machine becomes obsolete with the invention of more economical and sophisticated machine whose productive capacity is generally larger and cost of production less. In order to survive in the competitive market the manufacturer must install new machine replacing the old one, Again, it may happen that the articles produced by old machine are no longer saleable in the market on Account of change of habit and taste of the people. In such a case the old machine, although in good working condition, must be discarded and the new one purchased.

(b) Efflux of Time:

Some assets diminish in value on Account of sheer passage of time even though they are not used. e.g. Leasehold Property, Patent Right, Copyright etc. Suppose, we take a lease of a house for 10 years for Rs. 10,000. Its annual depreciation will be Rs. 1,000 (10,000 ÷ 10), irrespective of whether the house has been used or not. Because with the end of lease after 10 years, the house will go out of our possession.

(c) Accident:

Assets may be destroyed by abnormal reasons such as, fire, earthquake, flood etc. In such a case the destroyed asset must be written off as loss and a new one purchased.

NEED FOR PROVISION OF DEPRECIATION

The need for provision for depreciation arises for the following reasons:

(1) ASCERTAINMENT OF TRUE PROFIT OR LOSS:

Depreciation is a loss. So unless it is considered like all other expenses and losses, true profit/loss cannot be ascertained. In other words, depreciation must be considered in order to find out true profit/loss of a business.

(2) ASCERTAINMENT OF TRUE COST OF PRODUCTION:

Goods are produced with the help of plant and machinery which incurs depreciation in the process of production. This depreciation must be considered as a part of the cost of production of goods. Otherwise, the cost of production would be shown less than the true cost. Sale price is normally fixed on the basis of cost of production, the sale price will also be fixed at a low level resulting in loss to the business.

(3) TRUE VALUATION OF ASSETS:

Value of assets gradually decreases on Account of depreciation. If depreciation is not taken into Account, the value of asset will be shown in the books at a figure higher than its true value and hence the true financial position of the business will not be disclosed through Balance Sheet.

(4) REPLACEMENT OF ASSETS:

After some time an asset will be completely exhausted on Account of use. A new asset must then be purchased requiring a large sum of money. If the whole amount of profit is withdrawn from business each year without considering the loss on Account of depreciation, necessary sum may not be available for buying the new asset. In such a case the required money is to be collected by introducing fresh capital or by obtaining loan or by selling some other assets. This is contrary to sound commerce policy.

(5) KEEPING CAPITAL INTACT:

Capital invested in buying an asset, gradually diminishes on Account of depreciation. If loss on Account of depreciation is not considered in determining profit/loss at the year end, profit will be shown more. If the excess profit is withdrawn, the working capital will gradually reduce, the business will become weak and its profit earning capacity will also fall.

(6) LEGAL RESTRICTION:

According to provisions of Companies Ordinance 1984 dividend cannot be declared without charging depreciation on fixed assets. Thus in case of joint stock companies charging of depreciation is compulsory.

DEPRECIATION Vs. FLUCTUATION

Depreciation of asset and fluctuation in its market value are not the same thing. Suppose, a businessman purchases a machine the life of which is estimated at 10 years and charges depreciation accordingly each year. If for certain reasons the market value of that machine decreases by, say 20 %, the businessman need not consider this decrease at all. Because, the productive capacity or the utility of the machine to the business has not been reduced on Account of fall in its market value. So he will not have to suffer any loss, unless he sells the machine. But the machine is not intended for sale – it will be used permanently in the business. So the business will ignore the fall in market price. But depreciation cannot be ignored – it must be considered. Thus we see that there is no relationship between depreciation and fluctuation. The points of distinction between the two are stated below in a tabular form:

Depreciation	Fluctuation
1. It reduces productive capacity or utility of asset.	1. It does not reduce productive capacity or utility of asset.
2. It must occur.	2. It may not occur.
3. It reduces value of asset gradually.	3. The value of asset may rise or fall on Account of fluctuation.
4. Loss by way of depreciation must be considered.	4. Generally, it is not taken into Account. However, in case of current assets permanent fall in price is considered.
5. It is regular loss – it must be charged throughout the working life of asset.	5. It is generally irregular.
6. It always indicates loss.	6. It may indicate either profit or loss. Increase in market value means profit, while decrease means loss.

CHARACTERISTICS OF DEPRECIATION

Depreciation has the following characteristics:

(1) Depreciation is charged in case of fixed assets only, e.g. Building, Plant and Machinery, Furniture etc. There is no question of depreciation in case of current assets – such as Stock, Debtors, Bills Receivable etc.

(2) Depreciation causes perpetual, gradual and continuous fall in the value of asset.

(3) Depreciation occurs till the last day of the estimated working life of asset.

(4) Depreciation occurs on Account of use of asset. In certain cases, however, depreciation may occur even if the assets are not used, e.g. Leasehold Property, Patent Right, Copyright etc.

(5) Depreciation is a charge against revenue of an Accounting period.

(6) Depreciation does not depend on fluctuations in market value of asset.

(7) The amount of depreciation of an Accounting year cannot be determined precisely – it has to be estimated. In certain cases, however, it may be ascertained exactly, e.g. Leasehold Property, Patent Right, Copyright etc.

(8) Total depreciation of an asset cannot exceed its depreciable value (cost less scrap value).

ASCERTAINMENT OF THE AMOUNT OR RATE OF DEPRECIATION

In order to determine the amount or rate of depreciation the following three points are to be considered:

1. Cost price of asset.
2. Estimated working life of asset.
3. Estimated scrap value of asset.

The points are discussed below in details:

1. COST PRICE OF AN ASSET:

Cost price includes all expenses involved in carrying and installing the asset to the site. All these expenses are collectively known as installation charge. Suppose, we buy a machine for Rs. 1,000 and spend Rs. 200 and Rs. 300 for its carrying and installing respectively. Here, the cost price will be Rs. 1,500 (1,000 + 200 + 300). Installation charge is regarded as capital expenditure and debited to concerned Asset Account.

2. ESTIMATED WORKING LIFE OF AN ASSET:

Working life means the period during which the asset will help earning income of business. The following two points need consideration in order to determine working life:

(i) **Extent of Loss on Account of use:**

It depends upon the nature and quantum of use of asset. The more the asset is used and the more carelessly the asset is utilized, the less is its working life. For example, compared to private car taxi is used for a longer time and more carelessly. So, the working life of taxi will be less than that of private car.

(ii) **Obsolescence:**

In order to determine working life of an asset, one must consider obsolescence. But it is very complicated, since it is not known beforehand. So, it is not generally considered.

3. ESTIMATED SCRAP VALUE OF ASSET:

Scrap value means the price at which an asset will be sold at the end of its working life. Every asset has a limited life. After use for some time the asset is reduced to such a condition that it can no longer be used as asset. Then its scrap is either thrown out or sold at break–up value or by weight. The money realized by sale is known as Scrap Value or Residual Value.

Total depreciation to be charged on an asset is determined by the following formula:

COST–SCRAP VALUE

The amount of annual depreciation depends upon the method of charging depreciation.

METHODS OF CHARGING DEPRECIATION

Total depreciation on an asset must be written off as loss over its working life. There are several methods of determining the amount of depreciation to be charged each year. These methods are discussed below:

1. FIXED INSTALMENT OR STRAIGHT LINE METHOD:

Under this method depreciation of an asset will be equal each year. Annual depreciation is ascertained by the following formula:

$$\frac{\text{Cost} - \text{Scrap Value}}{\text{Estimated Life}}$$

Suppose, cost price of an asset Rs. 2,500, scrap value Rs. 500 and life 5 years. Annual depreciation will be Rs. 400 $\left(\frac{2500-500}{5}\right)$.

Depreciation is usually expressed as rate per cent per annum on cost of asset. It is ascertained by the following formula:

$$\frac{\text{Annual Depreciation}}{\text{Cost}} \times 100$$

In the above example the rate of depreciation will be 16 % p.a. $\left(\frac{400}{2,500} \times 100\right)$.

The rate may also be calculated on the basis of depreciable value of asset (i.e., cost less scrap value) *instead* of cost, in which case the formula is:

$$\frac{\text{Annual Depreciation}}{\text{Depreciable Value}} \times 100$$

According to this formula the rate of depreciation in the above example will be:

$$20\ \%\ \text{p.a.}\ \left(\frac{400}{2,500 - 500} \times 100\right)$$

Under this method the amount of depreciation will be equal every year, since depreciation is charged at a fixed rate on cost of asset. This is the special feature of this method.

If the annual depreciation is plotted on a graph paper, it will show a straight line, since the amount of depreciation is equal every year. This is why this method is also called ***Straight line method.***

This method is suitable to those assets whose life can be easily estimated and which render more or less equal service over their life time, e.g. Leasehold Property, Patent Right, Trade mark, Copyright etc.

MERITS:

(i) Simplicity (ii) the asset can be written off to zero value under this method (iii) this method is useful for providing depreciation on Leasehold property, patents and other like assets.

DEMERITS:

This method has following disadvantages:

(i) With the passage of time efficiency of asset decreases but the amount of depreciation remains the same which does not seem to be justified.

(ii) If assets are purchased during the year, the calculation of comparative depreciation creates certain problems.

(iii) No provision is made for interest on amount invested in the purchase of asset.

JOURNAL ENTRIES:

Under this method depreciation is recorded as follows:

(i) When depreciation is provided

Depreciation Account .... Dr.

Asset Account

(Being depreciation charged on – @ – for the year)

(ii) **When depreciation is transferred to profit and loss Account**

Profit & Loss Account .... Dr.

Depreciation Account

(Being depreciation Account transferred to profit and loss Account)

(iii) **When asset is sold on expiry of its useful life**

Bank Account .... Dr.

Asset Account

(Being scrap of asset sold)

(iv) **If profit is earned on sale of asset**

Asset Account .... Dr.

Profit and loss Account

(Being profit on sale of scrap transferred to profit and loss Account)

ILLUSTRATION NO. 1

On 1st January 1992, a machine was purchased for Rs. 40,000. Rate of depreciation is 10 % p.a. Prepare machinery Account for 3 years when depreciation is charged under fixed installment method.

Solution:

Dr. MACHINERY ACCOUNT Cr.

		Rs.			Rs.
1992 Jan. 1	Bank A/c	40,000	1992 Dec. 31	Depreciation @ 10 % on Rs. 40,000	4,000
				Balance c/d	36,000
		40,000			40,000
1993 Jan. 1	*Balance b/d*	*36,000*	1993 Dec. 31	Depreciation @ 10 % on Rs. 40,000	4,000
				Balance c/d	32,000
		36,000			36,000
1994 Jan. 1	*Balance b/d*	*32,000*	1994 Dec. 31	Depreciation @ 10 % on Rs. 40,000	4,000
				Balance c/d	28,000
		32,000			32,000
1995 Jan. 1	*Balance b/d*	*28,000*			

ILLUSTRATION NO. 2

A company, whose Accounting year is calendar year, purchased on 1st April 1993 machinery costing Rs. 30,000.

It purchased further machinery on 1st Oct. 1993 costing Rs. 20,000 and on 1st July 1994 costing Rs. 10,000.

On 1st January 1995, one–third of the machinery installed on 1st April, 1993 became obsolete and was sold for Rs. 3,000.

Show how machinery Account would appear in the books of company, if machinery was depreciated by fixed installment method at 10 % p.a. What would be the balance of machinery Account on 1st January 1996?

Solution:

Dr. MACHINERY ACCOUNT Cr.

		Rs.				Rs.
1993			1993			
April 1	Bank A/c	30,000	Dec. 31	Depreciation:		
Oct. 1	Bank A/c	20,000		On 30,000 for 9 months	2,250	
				On 20,000 for 3 months	500	2,750
			Dec. 31	Balance c/d		47,250
		50,000				50,000
1994			1994			
Jan. 1	Balance b/d	47,250	Dec. 31	Depreciation:		
July 1	Bank A/c	10,000		On 50,000 for full year	5,000	
				On 10,000 for 6 months	500	5,500
				Balance c/d		51,750
		57,250				57,250
1995			1995			
Jan. 1	Balance b/d	51,750	Jan. 1	Bank A/c		3,000
			Dec. 31	Profit and loss A/c		5,250*
			Dec. 31	Depreciation		5,000
			Dec. 31	Balance c/d		38,500
		51,750				51,750
1996						
Jan. 1	Balance b/d	38,500				

* Cost of machinery sold:

$\frac{1}{3}$ of machinery installed on 1.1.1993 $= \frac{30,000}{3} =$		10,000
Book value of 1/3 machine on 1.1.1995		
– Depreciation for 9 months of 1993	750	
– Depreciation for 12 months for 1994	1,000	1,750
		8,250
Sales proceeds		3,000
Loss on sale		5,250

2. **REDUCING BALANCE OR DIMINISHING BALANCE METHOD:**

Under this method depreciation is charged at a fixed rate like fixed installment method. But the rate per cent is not calculated on cost of asset as is done under fixed installment method – it is calculated on the book value of asset. The book value of an asset is obtained by deducting depreciation from its cost. The book value of asset gradually reduces on Account of charging depreciation. Since the depreciation rate per cent is applied on reducing balance of asset, this method is called Reducing Balance or diminishing balance method. The calculation of depreciation under this method will be clear from the following table:

Suppose, cost of asset is Rs. 1,000 and rate of depreciation 10 % p.a.

		Rs.	
Cost of asset		1,000	
Depreciation:	I year: 10 % of 1,000	100	
	Book Value	900	
	II year: 10 % of 900	90	
	Book Value	810	
	III year: 10 % of 810	81	
	Book Value	729	and so on.

It may be observed that the amount of annual depreciation is gradually reducing. But under fixed installment method the amount remains the same (i.e. Rs. 100).

ILLUSTRATION NO. 4 *(Change from straight line to diminishing balance method)*

A company purchased a second–hand machine on 1st January 1993 for Rs. 37,000 and immediately spent Rs. 2,000 on its repairs and Rs. 1,000 on its erection. On 1st July, 1994 it purchased another machine for Rs. 10,000 and on 1st July 1995 it sold off the first machine for Rs. 28,000 and bought another for Rs. 25,000. On 1st July 1996 the second machine was also sold off for Rs. 2,000.

Depreciation was provided on machinery @ 10 % p.a. on the original cost annually on 31st December. In 1994, however, the company changed the method of providing depreciation and adopted the written down value method, rate of depreciation being 15 % p.a. Give the machinery Account for four years commencing from the acquisition of first machine. Compute to nearest rupee.

Dr. MACHINERY ACCOUNT Cr.

Date	Particulars	Rs.	Date	Particulars	Rs.
1993			1993		
Jan. 1	Bank A/c	37,000	Dec. 31	Depreciation @ 10 % on Rs. 40,000 for one year	4,000
Jan. 1	Bank A/c	3,000	Dec. 31	Balance c/d	36,000
		40,000			40,000
1994			1994		
Jan. 1	Balance b/d	36,000	Dec. 31	Depreciation A/c @ 15 % on Rs. 36,000 for 1 year and on Rs. 10,000 for 1/2 year	6,150
July 1	Bank A/c	10,000	Dec. 31	Balance c/d	39,850
		46,000			46,000
1995			1995		
Jan. 1	Balance b/d	39,850	July 1	Bank A/c	28,000
July 1	Bank A/c	25,000	Dec. 31	Profit and loss A/c loss (1)	305
			Dec. 31	Depreciation A/c (2)	5,558
			Dec. 31	Balance c/d	30,987
		64,850			64,850
1996			1996		
Jan. 1	Balance b/d	30,987	July 1	Bank A/c	2,000
			Dec. 31	Profit & loss A/c (loss on sale) (3)	5,272
			Dec. 31	Depreciation (4)	4,059
			Dec. 31	Balance c/d	19,656
		30,987			30,987

WORKING NOTES:

1. **Loss on sale of 1st machine:-**

	Rs.
Original cost on 1.1.1993	40,000
Depreciation for the year 1993 @ 10 %	4,000
W.D.V. on 1.1.1994	36,000
Depreciation for the year 1994 @ 15 %	5,400
W.D.V. on 1.1.1995	30,000
Depreciation for 1/2 year @ 15 %	2,295
	28,305
Less selling price recovered	28,000
Loss	305

2. **Depreciation:-**

On (Rs. 10,000 – Rs. 750) 9,250 for 1 year @ 15 %	1,388
On Rs. 25,000 for 6 months @ 15 %	1,875
On Rs. 30,600 for 6 months @ 15 %	2,295
	5,558

3. **Loss on sale of II machine:-**

Original cost on 1.7.1994	10,000
Less depreciation for 6 months @ 15 %	750
W.D.V. on 1.1.1995	9,250
Depreciation for the year 1995 @ 15 %	1,388
W.D.V. on 1.1.1996	7,862
Depreciation for 1/2 year of 1996 @ 15 %	590
W.D.V. on 1.7.1996	7,272
Sale price recovered	2,000
Loss on sale	5,272

4. **Depreciation:**

On (Rs. 30,987 – Rs. 7,862) Rs. 23,125 for one year @ 15 %	3,469
On 7,862 for 1/2 year @ 15 %	590
	4,059

3. YEAR'S DIGITS OR SUM OF YEAR'S DIGITS METHOD:

This method has been introduced by American Accountants recently. It is an improvement over diminishing balance method. Here also the depreciation charge constantly reduces. This method is normally applied to fairly long lived assets. Unlike the diminishing balance method, a constantly decreasing rate is applied on the original cost. Hence the original book value is, like straight line method, reducible to zero. The determination of rate of depreciation is very simple. It simply sums up the years in an asset's lifespan to be used as denominator, and reverses the individual year numbers to be used as numerator. Thus if cost, residual value and life of an asset are:

Rs. 75,000, Rs. 3,000 and 8 years, the denominator will be:

$$1 + 2 + 3 + 4 + 5 + 6 + 7 + 8 = 36$$

The numerators from first to 8th year will respectively be – 8, 7, 6, 5, 4, 3, 2, 1. Applying the rate to the depreciable cost 'original cost – residual value' i.e., Rs. 72,000, the depreciation charges for the first eight years will be:

Year	Opening Book Value	Depreciable Cost	Rate	Depreciation	Total Depreciation	W.D.V.
1	75,000	72,000	8/36	16,000	16,000	59,000
2	59,000	72,000	7/36	14,000	30,000	45,000
3	45,000	72,000	6/36	12,000	42,000	33,000
4	33,000	72,000	5/36	10,000	52,000	23,000
5	23,000	72,000	4/36	8,000	60,000	15,000
6	15,000	72,000	3/36	6,000	66,000	9,000
7	9,000	72,000	2/36	4,000	70,000	5,000
8	5,000	72,000	1/36	2,000	72,000	3,000

Sum of year's digits can be easily computed by the formula:

$$S = \frac{n(n+1)}{2}$$

where: S = Sum of years

n = number of years of assets useful life.

Applying it when $n = 8$ years.

$$S = \frac{8(8+1)}{2} = \frac{72}{2} \text{ or } 36$$

4. ANNUITY METHOD:

Under this method the cost of asset is regarded as investment and interest at fixed rate is calculated thereon. Had the proprietor invested outside the business, an amount equal to the cost of asset, he would have earned some interest. So as a result of buying the asset the proprietor loses not only cost of asset by using it, but also the above mentioned interest. Hence depreciation is calculated in such a way as will cover both the above mentioned losses. The amount of annual depreciation is determined from Annuity Table, an extract from which is given below.

This method is particularly applicable to those assets whose cost is heavy and life is long and fixed, e.g. Leasehold Property, Land & Building etc.

Amount required to write off Re. 1 by the Annuity Method or Annuity payable yearly, which Re. 1 will purchase:

ANNUITY TABLE

Year	3 %	$3\frac{1}{2}$ %	4 %	$4\frac{1}{2}$ %	5 %
3	.353530	.356034	.360348	.363770	.367208
4	.269027	.372251	.275490	.278743	.282011
5	.218354	.221481	.224627	.227791	.230975
10	.117230	.120241	.123290	.126378	.129504
15	.083766	.086825	.089941	.093113	.096343
20	.067215	.070361	.070361	.076876	.080242

ILLUSTRATION NO. 5

On 1st January, 1991, a business purchased a three years' lease of premises for Rs. 10,000 and it was decided to depreciate the lease by Annuity Method calculating Interest at 5 per cent per annum. Show the leasehold property Account for 3 years.

Solution:

By referring to the above table, we find that .367208 is the amount of annual depreciation to write off Re. 1 in three years by Annuity Method; therefore to write off Rs. 10,000, the annual depreciation will be .367208 × 10,000 or Rs. 3,672.08.

LEASEHOLD PROPERTY ACCOUNT

		Rs.	P			Rs.	P
1994				1994			
Jan. 1	Cash A/c	10,000	—	Dec. 31	Depreciation A/c	3,672	08
Dec. 31	Interest A/c	500	—	Dec. 31	Balance	6,827	92
		10,500	—			10,500	—
1995				1995			
Jan. 1	Balance b/d	6,827	92	Dec. 31	Depreciation A/c	3,672	08
Dec. 31	Interest A/c	341	40	Dec. 31	Balance c/d	3,497	24
		7,169	32			7,169	32
1996				1996			
Jan. 1	Balance b/d	3,497	24	Dec. 31	Depreciation A/c	3,672	08
Dec. 31	Interest A/c	174	84				
		3,672	08			3,672	08

NOTE:

Net charge from P & L A/c can be ascertained as follows:

PROFIT & LOSS A/C

		Rs.	P			Rs.	P
1994 Dec. 31	Depreciation A/c	3,672	08	1994 Dec. 31	Interest	500	—
1995 Dec. 31	Depreciation A/c	3,672	08	1995 Dec. 31	Interest	341	40
1996 Dec. 31	Depreciation A/c	3,672	08	1996 Dec. 31	Interest	174	84

5. DEPRECIATION OR SINKING FUND METHOD:

Under this method a fund is created with the amount of annual depreciation. An amount equal to annual depreciation is invested each year in Government Papers or in some other gilt–edged securities outside the business. The income earned from investment is deposited into the fund and immediately reinvested. This process is carried on throughout the life of the asset and at the end of its life a sum equal to the cost of the asset is accumulated in the fund. Then the whole investment is sold and a new asset is acquired with the sale proceeds.

The special feature of this method is that the sum required to buy the new asset is available from Depreciation or Sinking Fund. As a result, the working capital of business is preserved. This method is specially applicable to costly machines in large–scale industries. The entries to be made will be as follows:

(a) At the end of first year:

(i) Debit profit and loss Account and credit depreciation fund Account with amount of annual depreciation.

(ii) Debit depreciation fund investment Account and credit bank Account with an equal amount.

(b) At the end of each subsequent year:

(i) Debit bank Account and credit depreciation fund Account with amount of interest earned on investments.

(ii) Debit profit and loss Account and credit depreciation fund Account with amount of annual depreciation.

(iii) Debit depreciation fund investment Account and credit bank Account with amount of annual depreciation plus interest received.

(c) In the last year:

(i) Debit bank Account and credit the depreciation fund Account with amount of interest earned.

(ii) Debit profit and loss Account and credit depreciation fund Account with amount of annual installment.

NOTE: In the last year this amount should not be invested in purchase of investments.

(iii) Debit bank Account and credit depreciation fund investment Account with proceeds of sale of investments – if any profit or loss on sale of investments, it should be transferred to depreciation fund Account.

(iv) Debit the Account of new asset and credit the bank Account with the cost of replacement.

(v) Debit depreciation fund Account and credit the Account of old asset which has now become useless.

In the balance sheet prepared during the period of building up the depreciation fund, depreciation fund Account shall be shown on the liabilities side and depreciation fund investment Account on assets side, whereas the asset for which this depreciation fund is being created will appear at its original cost.

The amount of annual depreciation to be provided for the depreciation will be ascertained from sinking fund tables, an extract from which is given below:

SINKING FUND TABLE

Periodic deposit which will amount to Re. 1

$$\left(\frac{i}{(1+i)^{n-1}}\right)$$

Period	3 %	4 %	5 %	6 %
1	1.000000	1.000000	1.000000	1.000000
2	.492611	.490196	.487805	.485437
3	.323530	.320348	.317209	.314110
4	.239027	.235490	.232012	.228591
5	.188355	.184627	.180975	.117396
6	.154597	.150762	.147017	.143363
7	.130506	.126610	.122820	.119135
8	.112456	.108528	.104772	.101036
9	.098434	.094493	.090690	.087022
10	.087231	.083291	.079505	.075868
15	.053767	.049941	.046342	.042963
20	.037216	.033582	.030243	.027185
25	.027428	.024012	.020952	.018227
30	.021019	.017830	.015051	.012649
35	.016539	.013577	.011072	.008974
40	.013262	.010523	.008278	.006462
45	.010785	.008262	.006262	.004701
50	.008866	.006550	.004777	.003444

ILLUSTRATION NO. 6

C acquires a 5 years' lease for Rs. 40,000. It is decided to provide for the renewal of lease immediately after 5 years by setting up a depreciation fund. It is expected that investments will fetch interest at 5 % p.a. Sinking Fund Table shows that Re 0.180975 invested each year will produce Re. 1 at the end of 5 years at 5 % p.a.

At the expiry of the lease, the Depreciation Fund Investments are sold for Rs. 31,205 and immediately thereafter the lease is renewed for a further period of 5 years by a payment of Rs. 44,000.

Make journal entries and prepare Lease, Depreciation Fund and Depreciation Fund Investment Accounts. Compute and invest to the nearest rupee.

Solution:

Annual depreciation = 40,000 × .180975 = 7239

		Rs.	Rs.
I Year Jan. 1	Lease Account Dr. Bank Account (Being lease purchased for 5 years)	40,000	40,000
Dec. 31	Profit and loss Account Dr. Depreciation fund Account (Being annual depreciation charged)	7,239	7,239
I Year Dec. 31	Depreciation fund investment Account Dr. Bank Account (Being amount of depreciation fund invested)	7,239	7,239
II Year Dec. 31	Bank Account Dr. Depreciation fund Account (Being interest received on depreciation fund investments)	362	362
Dec. 31	Profit and loss Account Dr. Depreciation fund Account (Being annual depreciation charged)	7,239	7,239

Dec. 31	Depreciation fund investment Account Dr.	7,601	
	Bank Account		7,601
	(Being investment purchased)		
III Year			
Dec. 31	Bank Account Dr.	742	
	Depreciation fund investment Account		742
	(Being interest of depreciation fund investments)		
Dec. 31	Profit and loss Account Dr.	7,239	
	Depreciation fund Account		7,239
	(Being annual depreciation charged)		
Dec. 31	Depreciation fund investment Account Dr.	7,981	
	Bank Account		7,981
	(Being investment purchased)		
IV Year			
Dec. 31	Bank Account Dr.	1,141	
	Depreciation fund Account		1,141
	(Being interest received on depreciation fund investments)		
Dec. 31	Profit and loss Account Dr.	7,239	
	Depreciation fund Account		7,239
	(Being annual depreciation charged)		
Dec. 31	Depreciation fund investment Account Dr.	8,380	
	Bank account		8,380
	(Being investments purchased)		
V Year			
Dec. 31	Bank Account Dr.	1,560	
	Depreciation fund Account		1,560
	(For interest received on sinking fund investments)		

Dec. 31	Profit and loss Account Dr.	7,239	
	Depreciation fund Account		7,239
	(Being annual depreciation charged)		
Dec. 31	Bank Account Dr.	31,205	
	Depreciation fund investment Account		31,205
	(Being depreciation fund investments sold)		
Dec. 31	Depreciation fund investment Account Dr.	4	
	Depreciation fund Account		4
	(Being the profit on the sale of investments transferred to depreciation fund account)		
Dec. 31	Depreciation fund Account Dr.	40,004	
	Less Account		40,000
	Profit and loss Account		4
	(For depreciation fund A/c transferred to lease Account)		
Dec. 31	Lease Account Dr.	44,000	
	Bank Account		44,000
	(Being new lease purchased for 5 years)		

LEASE ACCOUNT

		Rs.			Rs.
I year	Bank Account	40,000	I year	Balance c/d	40,000
II year	Balance b/d	40,000	II year	Balance c/d	40,000
III year	Balance b/d	40,000	III year	Balance c/d	40,000
IV year	Balance b/d	40,000	IV year	Balance c/d	40,000
V year	Balance b/d	40,000	V year	Depreciation fund A/c	40,000

Dr. **DEPRECIATION FUND ACCOUNT** Cr.

		Rs.			Rs.
I year			I year		
Dec. 31	Balance c/d	7,239	Dec. 31	Profit and loss A/c	7,239
I year			II year		
Dec. 31	Balance c/d	14,840	Jan. 1	Balance b/d	7,239
			Dec. 31	Bank	362
			Dec. 31	Profit and loss A/c	7,239
		14,840			14,840
III year			III year		
Dec. 31	Balance c/d	22,821	Jan. 1	Balance b/d	14,840
			Dec. 31	Bank	742
			Dec. 31	Profit and loss A/c	7,239
		22,821			22,821
IV year			IV year		
Dec. 31	Balance c/d	31,201	Jan. 1	Balance b/d	22,821
			Dec. 31	Bank A/c	1,141
			Dec. 31	Profit and loss A/c	7,239
		31,201			31,201
V year			V year		
Dec. 31	Lease Account	40,000	Jan. 1	Balance b/d	31,201
Dec. 31	Profit and loss A/c	4	Dec. 31	Bank A/c	1,560
			Dec. 31	Profit and loss A/c	7,239
				Dep. fund investment A/c	4
		40,004			40,004

Dr. **DEPRECIATION FUND INVESTMENT ACCOUNT** Cr.

		Rs.			Rs.
I year			I year		
Dec. 31	Bank A/c	7,239	Dec. 31	Balance c/d	7,239
II year			II year		
Jan. 1	Balance b/d	7,239	Dec. 31	Balance c/d	14,840
Dec. 31	Bank A/c	7,601			
		14,840			14,840
III year			III year		
Jan. 1	Balance b/d	14,840	Dec. 31	Balance c/d	22,821
Dec. 31	Bank A/c	7,981			
		22,821			22,821
IV year			IV year		
Jan. 1	Balance b/d	22,821	Dec. 31	Balance c/d	31,201
Dec. 31	Bank A/c	8,380			
		31,201			31,201
V year			V year		
Jan. 1	Balance b/d	31,201	Dec. 31	Bank A/c	31,205
	Depreciation fund Account	4			
		31,205			31,205

Relation between Annuity and Depreciation fund methods.

There is very close relationship between these two methods, because in both cases (a) compound interest is taken into Account (b) provision is made for replacement of asset and (c) there are equal annual charges to revenue.

SHORTCOMINGS OF DEPRECIATION FUND METHOD:

Depreciation fund method assumes a constant rate of return on investments in identical securities. This is hardly true, because rates of interest do vary every now and then. Variation of rate upsets the earlier

periodic allocation for depreciation and entails recitation. Further the amount realized on sale of security rarely agrees with its acquisition cost due to market fluctuations. This method cannot be used where any additions are made during the year to an asset.

6. INSURANCE POLICY METHOD:

This method is somewhat alike the Depreciation or Sinking Fund Method. The only difference is that the annual depreciation instead of investing in Government Papers of gilt–edged securities is paid as premium to an insurance company, who issues an insurance policy equivalent to cost of asset. At the end of the life of asset insurance company pays money covered by the policy and a new asset is purchased with it.

JOURNAL ENTRIES:

		Rs.	Rs.
(i)	**When premium is paid at the beginning of the year:**		
	Insurance policy A/c Dr.		
	Cash Account		
(ii)	**When depreciation is charged (equal to premium):**		
	Profit and loss A/c Dr.		
	Depreciation fund A/c		
(iii)	**When policy money is received on maturity:**		
	Cash A/c Dr.		
	Insurance policy A/c		
(iv)	**To Transfer the excess amount recd. over premium:**		
	Insurance policy A/c Dr.		
	Depreciation fund A/c		
(v)	**When asset is retired:**		
	Depreciation fund account Dr.		
	Asset Account		
(vi)	**When scrap is sold:**		
	Cash account Dr.		
	Asset Account		

ILLUSTRATION NO. 7

On 1st January 1994 a business purchased a three years lease of premises for Rs. 10,000 and it is decided to make provision for replacement of the lease by means of an insurance policy purchased for an annual premium of Rs. 3,200.

Show ledger Accounts dealing with the matter along with journal entries.

Solution:

			Rs.	Rs.
1994				
Jan. 1	Leasehold Account	Dr.	10,000	
	Bank Account			10,000
	(For lease purchased for 3 years)			
Jan. 1	Depreciation fund policy Account	Dr.	3,200	
	Bank Account			3,200
	(For leashold policy taken for replacement)			
Dec. 31	Profit and Loss Account	Dr.	3,200	
	Depreciation fund Account			3,200
	(For charge of premium against profits)			
1995				
Jan. 1	Depreciation fund policy Account	Dr.	3,200	
	Bank Account			3,200
	(For premium paid on leasehold policy)			
Dec. 31	Profit and loss Account	Dr.	3,200	
	Depreciation fund Account			3,200
	(For charge of premium against profits)			
1996				
Jan. 1	Depreciation fund policy Account	Dr.	3,200	
	Bank account			3,200
	(For premium paid on leasehold policy)			
Dec. 31	Profit and loss Account	Dr.	3,200	
	Depreciation on fund Account			3,200
	(For charge of premium against profit)			
Dec. 31	Depreciation fund Account	Dr.	10,000	
	Leasehold Account			10,000
	(For lease property retired)			
Dec. 31	Bank account	Dr.	10,000	
	Depreciation fund policy Account			10,000
	(For policy money received on maturity)			
Dec. 31	Depreciation fund policy Account	Dr.	400	
	Depreciation fund Account			400
	(Being transfer of policy Account to depreciation fund Account)			

LEASEHOLD ACCOUNT

		Rs.			Rs.
1994			1994		
Jan. 1	Bank Account	10,000	Dec. 31	Balance c/d	10,000
1995			1995		
Jan. 1	Balance b/d	10,000	Dec. 31	Balance c/d	10,000
1996			1996		
Jan. 1	Balance b/d	10,000	Dec. 31	Depreciation fund A/c	10,000

DEPRECIATION FUND ACCOUNT

		Rs.			Rs.
1994			1994		
Dec. 31	Balance c/d	3,200	Dec. 31	Profit and loss Account	3,200
1995			1995		
Dec. 31	Balance c/d	6,400	Jan. 1	Balance b/d	3,200
			Dec. 31	Profit and loss Account	3,200
		6,400			6,400
1996			1996		
Dec. 31	Leasehold A/c	10,000	Jan. 1	Balance b/d	6,400
			Dec. 31	Profit and loss Account	3,200
			Dec. 31	Depreciation fund policy Account	400
		10,000			10,000

DEPRECIATION FUND POLICY ACCOUNT

		Rs.			Rs.
1994			1994		
Jan. 1	Bank Account	3,200	Dec. 31	Balance c/d	3,200
1995			1995		
Jan. 1	Balance b/d	3,200	Dec. 31	Balance c/d	6,400
Jan. 1	Bank Account	3,200			
		6,400			6,400
1996			1996		
Jan. 1	Balance b/d	6,400	Dec. 31	Bank Account	10,000
Jan. 1	Bank Account	3,200			
Dec. 31	Depreciation fund Account	400			
		10,000			10,000

7. REVALUATION METHOD:

Under this system, the assets are revalued each year. The method is normally adopted to charge depreciation on numerous inexpensive fixed assets like small tools, live stock, patents, copy rights and other assets of such nature which are constantly changing and their period of life is most uncertain. Accordingly periodic inventory is taken of usable items and valued at cost irrespective of ruling prices. Excess of the opening over the closing inventory thus gives the periodic depreciation expenses.

For example, if the value of tools at the beginning of the year was Rs. 8,000, during the year tools worth Rs. 6,000 were purchased more and when at the end revaluation was undertaken it amounted to Rs. 11,000. The amount of depreciation for the year shall be as under:

Rs. (8,000 + 6,000) – 11,000 = Rs. 3,000

MERITS:

This method is very simple and the amount of loss can be ascertained very easily.

DEMERITS:

(i) As every year revaluation is desired it presents various problems.

(ii) Amount of depreciation is always unequal.

(iii) The valuation of assets is very time consuming.

8. DEPLETION METHOD:

In the case of wasting assets such as mines and quarries, which have to be replaced, depreciation is usually provided for on the depletion unit basis, which means that such a sum is provided each year as represents the expired capital outlay on the basis of output compared with the estimated total contents of the mine, etc. Thus if a stone quarry estimated to contain 1,00,000 tonnes of stone, is acquired for Rs. 5,000, the amount of depreciation to be provided will be 5 paise per tonne of stone raised.

ILLUSTRATION NO. 9

The Swat Mingrals Ltd. leased a manganese ore mine on June 30th 1993 for a sum of Rs. 5,00,000. It is estimated that total quantity of ore in the mine is 1,00,000 tonnes. The annual output is as follows:

Year	Tonnes	Year	Tonnes
1993	5,000	1995	16,000
1994	20,000	1996	21,000

Using the depletion method of depreciation, show the mine Account for the above 4 years.

Solution:

MINE ACCOUNT

		Rs.			Rs.
1993			1993		
June 30	Bank	5,00,000	Dec. 31	Depreciation	25,000
			Dec. 31	Balance c/d	4,75,000
		5,00,000			5,00,000
1994			1994		
Jan. 1	Balance b/d	4,75,000	Dec. 31	Depreciation	1,00,000
			Dec. 31	Balance c/d	3,75,000
		4,75,000			4,75,000
1995			1995		
Jan. 1	Balance b/d	3,75,000	Dec. 31	Depreciation	80,000
			Dec. 31	Balance c/d	2,95,000
		3,75,000			3,75,000
1996			1996		
Jan. 1	Balance b/d	2,95,000	Dec. 31	Depreciation	105,000
			Dec. 31	Balance c/d	1,90,000
		2,95,000			2,95,000
1997					
Jan. 1	Balance b/d	1,90,000			

NOTE: The depreciation each year will be @ Rs. 5 per tonne raised;

i.e., 5,00,000 ÷ 1,00,000

9. MACHINE HOUR RATE METHOD:

Under this method of depreciation, total number of working hours of a machine during the whole of its effective life is estimated, and then the cost of machine is divided by this estimated total number of working hours in order to arrive at the hourly rate which is multiplied by the number of hours the machine has been worked during the year to find out amount of depreciation for the period.

10. MILEAGE METHOD:

This method is used only for those assets whose useful life depends upon the fact that how many kilometres they have been driven e.g. buses, cars, trucks, and rolling stock etc. The depreciation on such assets depends on as to how many kilometres these assets have been driven. A car costing Rs. 12,000 was purchased and its useful life was estimated to be 48,000 kms. Its rate of depreciation will be 25 paise per kilometre. If during first year it is driven 10,000 kilometres, the amount of depreciation will be 10,000 × 25 = Rs. 2,500.

11. GLOBAL METHOD:

Under this method of depreciation the value of all the assets irrespective of their nature is added together and depreciation is charged at an average rate on aggregated value. It is not a scientific method of providing depreciation. So it should be avoided.

CHOICE OF A METHOD:

Study of aforesaid methods of depreciation reveals that none is absolutely best or worst as each method has its own merits and demerits. Suitability of every method is relative and depends on various considerations. Most important of these are the type of asset and purpose of depreciation.

Straight line method suits to buildings and lease etc.; reducing installment method fits to machinery, equipment etc. and depletion method for wasting assets like mines, quarries etc. However, the underlying purpose is the basic determinant of the propriety of a depreciation method. Important purposes comprise of true reporting of Accounts, tax benefits, competitive product cost, financial flexibility, replacement and expansions etc. For example, depreciation fund method envisages that the amount set aside for depreciation is to be invested outside the business in specific securities. Similarly, under insurance policy method the amount so set aside is handed over to insurance company. If a business is having working capital problems, the advisability of these methods is questionable.

DISTINCTION BETWEEN FIXED INSTALMENT METHOD AND REDUCING INSTALMENT METHOD

Fixed Installment Method	Reducing Installment Method
1. The rate and amount of depreciation remain the same each year.	1. The rate remains the same, but the amount of depreciation diminishes gradually.
2. Depreciation rate per cent is calculated on cost of assets each year.	2. Depreciation rate per cent is calculated on book value of asset.

3. At the end of its life the value of asset is reduced to zero or scrap value.	3. The value of asset is never reduced to zero at the end of its life.
4. The older the asset, the larger the cost of its repair. But the amount of depreciation remains the same each year. Hence, the total of depreciation and repairs increases every year. This reduces annual profit gradually.	4. The amount of depreciation decreases gradually, while the cost of repairs increases. So the total of depreciation and repairs remains more or less the same each year. Hence, it causes little or no change in annual profit/loss.
5. Computation of depreciation is comparatively easy and simple.	5. Depreciation can be computed without any difficulty, but it is not so easy and simple.

METHODS OF DEPRECIATION ACCOUNTING

There are two methods of Accounting of depreciation:

(1) DEPRECIATION ACCOUNT:

Under this method, Depreciation A/c is debited and Asset A/c is credited with the amount of annual depreciation. Suppose, the cost of a machine is Rs. 1,000 and its depreciation is 10 % p.a. The entries will be:

				Dr. Rs.	Cr. Rs.
	Depreciation A/c	Dr.		100	
	Machinery A/c				100
	(Being depreciation charged on machinery @ 10 % p.a.)				
	Profit & Loss A/c	Dr.		100	
	Depreciation A/c				100
	(Being transfer of depreciation)				

BALANCE SHEET AS AT

Assets	Rs.	Liabilities	Rs.
Machinery	1,000		
Less Depreciation 100	900		

(2) DEPRECIATION RESERVE ACCOUNT OR PROVISION FOR DEPRECIATION ACCOUNT:

Under this method, annual depreciation is debited to Depreciation A/c like the first method, but Asset A/c is not credited. Instead, a new Account styled "Depreciation Reserve A/c" is opened and annual depreciation is credited to it. As a result, Asset Account always remains at cost. If in the above example this method is applied, the entries will be:

			Dr Rs.	Cr. Rs.
	Depreciation A/c Depreciation Reserve A/c (Being depreciation charged on machinery @ 10 % p.a.)	Dr.	100	 100
	Profit & Loss A/c Depreciation A/c (Being transfer to depreciation)	Dr.	100	 100

BALANCE SHEET AS AT ....

Assets	Rs.	Liabilities	Rs.
Machinery	1,000	Depreciation Reserve*	100

NOTE: At the end of life time of asset Depreciation Reserve A/c is transferred to Asset A/c and thereby both the Accounts are closed.

It may be noted that under this method the balance of Depreciation Reserve A/c will gradually increase, the annual depreciation being credited to it each year. On the other hand, the balance of Asset A/c will remain constant. At any time the book value of asset will be the difference between the balances of Asset Account and Depreciation Reserve A/c. In the above example, the book value of machinery is Rs. 900 (1,000 – 100). Thus both the methods will produce the same result.

DISTINCTION BETWEEN DEPRECIATION A/C AND DEPRECIATION RESERVE A/C

The points of distinction between the two Accounts are given below in a tabular form:

Depreciation A/c	Depreciation Reserve A/c
1. Its balance is always debit.	1. Its balance is always credit.
2. At the year end its balance is transferred to Profit & Loss A/c and the Account is closed.	2. Its balance is not transferred to any Account. It is shown separately on liabilities side of Balance sheet or as deduction from the concerned asset on assets side of Balance Sheet. At the end of lifetime of the asset the Account is closed by transfer to the concerned asset Account.

* It may also be shown as deduction from machinery on assets side.

3. Its balance cannot increase, because the Account is usually opened on the last day of the year and the balance transferred to Profit & Loss A/c on the same day.	3. During the lifetime of the asset its balance gradually increases.
4. The book value of an asset can be obtained at a glance from the concerned asset Account.	4. Here the book value of asset cannot be so obtained. The book value can be obtained by deducting the balance of Depreciation Reserve A/c from that of the concerned asset Account.

RESERVE & PROVISION:

In actual practice the two words "Reserve" & "Provision" are used to mean the same thing – no distinction is drawn between them. For example, very often we see the use of the terms – Reserve for Doubtful Debt, Reserve for Discount, instead of Provision for Doubtful Debt, Provision for Discount etc. But in fact there is a sharp distinction between the two words.

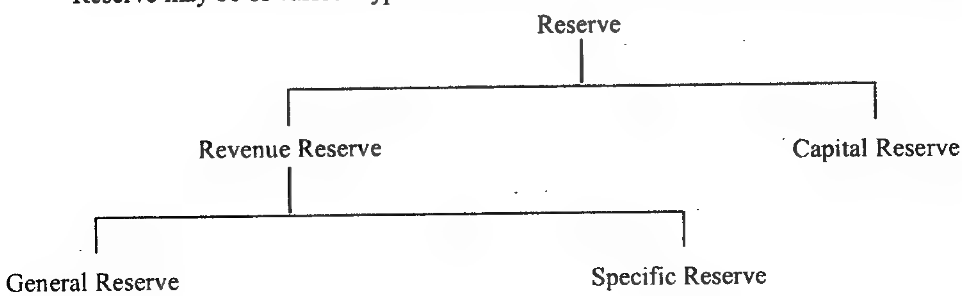
RESERVE

Profit earned by a business is payable to its proprietor. But the proprietor does not normally draw the whole amount of profit. He leaves a portion of profit in the business in order to increase working capital and to strengthen financial position of the business. This portion is known as **Reserve.** According to Yorston, Smyth & Brown, "Reserve should include amounts set aside out of profits and other surpluses which are not intended or necessary to meet any liability, contingency or diminution in the value of assets known to exist at the date of the Balance Sheet". It is the undistributed portion of profits of the business. Thus **the portion of profit which is not paid to proprietor, but is kept apart for meeting some known or unknown** losses is called Reserve, e.g. Reserve Fund, Contingency Fund etc. The amount is debited to P & L Appropriation A/c and credited to concerned Reserve Account.

It is to be noted that reserve can be created out of profit only. In other words, it cannot be created if the business incurs a loss.

CLASSIFICATION OF RESERVE

Reserve may be of various types. Its classification is shown below in a tabular form:



According to the method and object of creation, reserves may be of the following two types:

1. Revenue Reserve
2. Capital Reserve

1. REVENUE RESERVE:

Profit earned by a business through its normal activities is determined at the year end through Profit & Loss A/c. The portion of such profit which is not paid to the proprietor, but kept apart, is known as **Revenue Reserve.**

From the viewpoint of its creation revenue reserve may again be classified into two:

(a) General Reserve

(b) Specific Reserve

(a) General Reserve:

Reserve which is created not for any specific purpose, but for strengthening the financial position of the business, is known as General Reserve, e.g. Reserve Fund, Contingency Fund etc. It is a matter for the proprietor or management of business to decide whether general reserve will at all be created or if created, with what amount. Usually there is no compulsion on this point. But in case of joint stock company a specific % of profit is to be transferred to General Reserve before it pays dividend to its shareholders.

General Reserve is created for the following purposes:

(i) To strengthen the financial position of business.

(ii) To increase working capital of business.

(iii) To meet future contingencies.

(iv) To meet any unknown liability or loss.

From the purposes stated above it will be clear that general reserve is created not for any specific purpose.

N.B:

This type of reserve is created out of regular or normal profit of business. So the proprietor of the business is free to get it as share of profit. That is way it is also known as Free Reserve.

(b) Specific Reserve:

Reserve created for any special purpose is known as **Specific Reserve,** viz, Dividend Equalization Fund, Debenture Sinking Fund etc. This reserve will be utilized for the very purpose for which it has been created – it cannot be utilized for any other purpose. For example, a company generally creates Debenture Sinking Fund for the purpose of repayment of debenture. Such Fund will be utilized only for the purpose of repaying debenture. It is also known as **Special Reserve.**

DISTINCTION BETWEEN GENERAL RESERVE & SPECIFIC RESERVE

Both are created out of profit earned in the normal course of business. Yet the following distinctions are observed between the two:

General Reserve	Specific Reserve
1. It is created not for any specific purpose. It is created to strengthen the financial position of business.	1. It is created for some specific purpose. For example, Debenture Sinking Fund is created for the purpose of repaying loan on Account of debenture.
2. It can be utilized for any purpose.	2. It can be utilized only for the purpose for which it has been created – it cannot be utilized for other purpose.
3. In case of need dividend can be paid out of it.	3. Dividend cannot be paid out of it. But on fulfillment of the objective for which a fund has been created the fund will no longer be required, when dividend may be paid out of it. For example, on repayment of loan on Account of debenture the Debenture Sinking Fund is not required. Then it is transferred to General Reserve Fund. In other words, the fund money is distributable as dividend.

2. CAPITAL RESERVE:

Profit may arise from sources other than normal trading activities. Such profit is known as capital profit. Any reserve created out of such profit is called **Capital Reserve.** It is usually not available for payment to shareholders as dividend – it is utilized for meeting capital losses. "The expression 'Capital Reserve' shall not include any amount regarded as free for distribution through the P & L A/c". Such profit is earned in the following ways:

(a) Sale of fixed asset

(b) Revaluation of assets and liabilities

(c) Issue of shares and debentures at a premium

(d) Profit pior to is incorporation

(e) Redemption of debenture at a discount.

In addition to this, another type of reserve is created, the existence of which is not disclosed through Balance Sheet or the books of Account. It is called **Secret Reserve**

e. Generally, the type of business whose success is dependent on public confidence (e.g. banks, insurance companies and other financial institutions) create such reserve in order to strengthen financial position of their concern. This is usually created by undervaluing assets and overvaluing liabilities. It may be noted that no special entries are made in the books of Account in order to create such reserve.

DISTINCTION BETWEEN CAPITAL RESERVE AND GENERAL RESERVE

The points of distinction between the two are given below in a tabular form:

Capital Reserve	General Reserve
1. It is created out of profit earned not in the normal course of business. For example, to a bookseller, profit on sale of books is a regular profit. But profit earned on sale of something other than books is capital profit.	1. It is created out of profit earned in the normal course of business.
2. Capital employed in business is increased permanently.	2. It increases capital employed temporarily.
3. It is usually not available for payment of dividend.	3. It is available for payment of dividend.
4. Liability & Loss of capital nature only can be met by it.	4. It is available for meeting any type of liability or loss.

DISTINCTION BETWEEN RESERVE AND RESERVE FUND

In this connection it is important to note the distinction between Reserve and Reserve Fund. We know that a portion of profit instead of paying to the proprietor is utilized in creating reserve. The amount of reserve may be used as additional capital written the business. It is so done, specially when the working capital is inadequate to the needs of business. In that case it is called only Reserve. But in many cases the amount of reserve is invested outside the business in Government papers or in gilt–edged securities, then it is known as Reserve Fund. Thus, the amount of reserve which is not invested outside the business is only Reserve, while reserve invested outside the business in some quickly saleable assets is Reserve Fund. However, in actual practice no distinction is usually drawn between the two, i.e. Reserve and Reserve Fund are used in the same sense.

Suppose, a business has earned a profit of Rs. 8,000 for the year ended 31.12.1995 and 10 % of the profit is to be transferred to reserve. The entry will be:

P & L Appropriation A/c	Dr.	Rs. 800	
Reserve A/c			Rs. 800

(Being the amount of profit appropriated to reserve)

BALANCE SHEET AS AT 31.12.1995 (INCLUDES)

Assets	Rs.	Liabilities	Rs.
		Reserve	800
		P & L Appropriation A/c	7,200

If the amount of reserve is invested outside the business, there will be an additional entry:

Reserve Fund Investment A/c Dr. Rs. 800

Bank A/c Rs. 800

(Being the amount of reserve invested)

BALANCE SHEET AS AT 31.12.1995 (INCLUDES)

Assets	Rs.	Liabilities	Rs.
Reserve Fund Investment	800	Reserve Fund	800
		P & L Appropriation A/c	7,200

ADVANTAGES OF RESERVE FUND

The following advantages are obtained from Reserve Fund:

(1) Regular income is earned from investment.

(2) The investment having been made in Government Papers or gilt–edged securities the amount of reserve is safe.

(3) Money can be obtained by selling investments, whenever necessary.

(4) There may be profit on sale of investments, if market price rises. There will, however, be loss, if market price falls.

PROVISION

Provision means providing for possible loss or liability, the amount of which cannot be determined exactly, e.g. Provision for Doubtful Debt. Since it is not possible to determine exactly the portion of current year's debt which will turn bad next year, it is necessary to make provision therefore. If it was possible to determine it exactly, there would have been no necessity for creating provision – the amount would be straightway debited to Profit & Loss A/c as bad debt. The provision is created for the following purposes:

(i) Depreciation of assets.

(ii) Renewal of assets.

(iii) Diminution in the value of assets.

(iv) Unknown liability, the amount of which cannot be determined exactly.

DISTINCTION BETWEEN PROVISION AND RESERVE

The points of distinction between provision and reserve are stated in the tabular form:

Provision	Reserve
1. It is a possible loss. So it is created by debiting Profit & Loss A/c – it is a charge against profit.	1. It is a portion of profit earned by a business. It is created by debiting Profit & Loss Appropriation A/c – it is an appropriation of profit.

2. Profit & Loss A/c will not disclose true profit/loss, unless provision is created.	2. Profit & Loss A/c discloses true profit/loss, even if no reserve is created.
3. It is created to meet specific loss or liability. But the amount of loss or liability cannot be determined exactly. So the amount of provision is an estimated amount.	3. It is meant for meeting any unknown loss or liability. It is generally created with a portion of profit earned by business.
4. It must be created irrespective of whether there is profit or loss. In other words, its creation is obligatory.	4. It cannot be created unless there is sufficient profit. Its creation is the discretion of management. In other words, it is not obligatory.
5. Profit or loss is affected by its creation – profit decreases or loss increases.	5. It does not affect profit or loss, since it is created after ascertaining net profit.
6. Dividend cannot be paid out of it.	6. Dividend can be paid out of it.
7. Its amount must be sufficient to meet the loss or liability.	7. Its amount is generally determined by management on the basis of the amount of profit earned.
8. It cannot increase working capital – it is utilized for meeting the specific loss or liability.	8. It increases working capital and thereby strengthens the financial position of the business concern.
9. The owner of the business cannot have any claim over it, since it is created for meeting a specific loss or liability.	9. The owner can claim it, since it is created out of profit.
10. It is shown on 'Assets' side of Balance Sheet as deduction from the concerned asset, e.g. Provision for doubtful Debt is shown as deduction from Sundry Debtors.	10. It is shown on 'Liabilies' side of Balance Sheet as a separate item.
11. It is utilized for the specific purpose for which it has been created.	11. It can be utilized for the purpose whatsoever.
12. Auditor must check its adequacy.	12. Auditor is not required to check adequacy.

In spite of the above distinction between provision and reserve it may be noted that both of them are created out of the same source, i.e. revenue of the business. Again, if there be any surplus provision after meeting the liability or loss for which it was created, such surplus provision is as good as reserve. For example, suppose, a provision of Rs. 500 is created in this year for doubtful debt. But actual bad debt in the next year comes to Rs. 400 only leaving a surplus provision of Rs. 100 (500 – 400). This surplus will be credited to Profit & Loss A/c. In other words, it becomes payable to the owner of business like reserve.

QUESTIONS

1. What is depreciation, how does it arise and why should an adequate provision be made for it? In what manner is such provision recorded in the books?
2. Enumerate the methods of calculating depreciation. Discuss briefly the merits and demerits of each method.
3. Which method of charging depreciation would you recommend for the following and why:-
   (i) Freehold building (ii) Long–term lease (iii) Loose tools.
4. Define briefly depreciation and explain the connection of depreciation with (i) profit, (ii) price fluctuations (iii) repairs and (iv) replacement.
5. A newly–established concern has acquired the following assets:
   (i) Lease hold property, (ii) loose tools, (iii) coal mine, (iv) power plant. You are required to suggest the suitable method of depreciation for each of these items, giving reasons in support of each method.
6. In each of the following cases indicate the alternative which you consider to be correct:
   (a) Depreciation is a process of:
   (i) Valuation, (ii) allocation, (iii) both of valuation and allocation, (iv) none of these.
   (b) The main object of providing depreciation is:
   (i) to calculate true profit, (ii) to show true financial position, (iii) to reduce tax burden, (iv) to provide funds for replacement.
   (c) Depreciation arises because of:
   (i) Fall in the market value of an asset, (ii) physical wear and tear, (iii) fall in the value of money.
   (d) Under the straight line method of charging depreciation, it:
   (i) increases every year, (ii) is constant every year, (iii) decreases every year.
   (e) Under the diminishing balance method, depreciation is calculated on:
   (i) the scrap value, (ii) the original cost, (iii) book value.
   (f) The amount of depreciation charged on a machinery will be debited to:
   (i) Machinery A/c, (ii) depreciation A/c, (iii) cash A/c.
   (g) A diminishing balance method of providing for depreciation is one according to which:
   (i) the rate percent at which depreciation is written off goes on declining from year to year.
   (ii) the amount on which depreciation is provided is reduced from year to year.
   (iii) the rate percent and also the amount are reduced from year to year.
   (h) Loss on the sale of plant and machinery should be written off against:
   (i) Share premium Account, (ii) depreciation fund Account, (iii) sales Account.

Ans: *[(a) (ii); (b) (i); (c) (ii); (d) (ii); (e) (iii); (f) (ii); (g) (ii); (h) (ii)]*

PROBLEMS

1. X & Co. purchased a machinery for Rs. 70,000 on 1st July, 1990. They spent Rs. 8000 on its installation. Prepare the machinery Account for the first four years under straight line method of depreciation. Depreciation is written off at 10 % per annum. Assume the Accounts are closed every year on 31st December.

Ans: *[Balance of Machinery Account on 31.12.1993 Rs. 50700]*

2. A firm purchased a machine for Rs. 210,000 on 1st July, 1991 and spent Rs. 24000 as wages and installation charges. Prepare the machine Account for the first four years under Diminishing Balance Method of depreciation assuming that the Accounting year of the firm ends on 31st December every year. Rate of Depreciation is 10 % per annum.

Ans: *[Balance of Machinery Account on 31.12.1994 Rs. 162057]*

3. On 1st January, 1992 a firm purchased machinery worth Rs. 50,000. On 1st July, 1994 it buys additional machinery worth Rs. 10,000 and spends Rs. 1000 on its erection. The Accounts are closed each year on 31st December. Assuming the normal depreciation to be 10 % p.a., show the Machinery Account for five years under (1) Fixed Installment Method and (2) Reducing Installment Method.

Ans: *[(1) Balance of Machinery Account Rs. 33250*
(2) Balance of Machinery Account Rs. 37989]

4. A firm purchased a second–hand truck for Rs. 50,000 on 1st January, 1990 and spent Rs. 20,000 on its overhauling. Depreciation is written off 10 % p.a. on the reducing balance. On 30th June, 1993 the truck was sold for Rs. 30,000 being unsuitable. Prepare the Truck Account from 1990 to 1993 assuming that Accounts are closed on 31st December every year.

Ans: *[Loss on Sale of Truck Rs. 18478]*

5. Show Machinery Account under (1) written down value method and (2) Original cost method for three years from the information given below:

(a)	Machinery cost	Rs. 200,000
(b)	Estimated Life	3 years
(c)	Rate of depreciation	$33\frac{1}{3}$ % p.a.
(d)	Residual value	Rs. 20,000

Ans: *[(2) Residual value balance Rs. 20,000 at the end of 3rd year.*
(1) Balance of Machinery Account Rs. 59260 at 3rd year end.]

Note: Under written down value method depreciation should be calculated without considering residual value.

6. On 1st July 1991, Basharat purchased machinery for Rs. 60,000. Depreciation is to be provided for at 10 % on diminishing balance each year. On 31st October, 1993 $\frac{1}{4}$ of Machinery was sold for Rs. 6000 as they became useless. On the same date he purchased a new machinery for Rs. 20,000. Prepare machinery Account from 1991 to 1994. Accounts are closed on 31st December every year.

Ans: *[Loss on sale of machinery Rs. 5756*
Balance of Machinery A/c on 31.12.1994 Rs. 48865]

7. A transport company purchases 10 motor trucks at Rs. 90,000 each on 1st April, 1992. On 1st October, 1994 one of the trucks got an accident and was completely destroyed. Rs. 54000 are received from the insurer in full settlement. On the same day another truck was purchased for the sum of Rs. 100,000. The company wrote off depreciation at 20 % on the

original cost per annum and observed the calendar year as its financial year. Give the motor trucks account from 1992 to 1995.

Ans: [Balance of Trucks Account on 31.12.1995 Rs. 277500
Capital profit Rs. 9000]

8. A company purchased a second–hand machine on 1st Jan., 1990 for Rs. 37000 and immediately spent Rs. 2000 on its overhauling and Rs. 1000 on its erection. On 1st July 1991, it purchased another machine for Rs. 10,000 and on 1st July, 1992 it sold off the first machine purchased in 1990 for Rs. 28000. It purchased a machine for Rs. 25000 on 1st July, 1992. On 1st July, 1993 the second machine purchased for Rs. 10,000 was sold off for Rs. 2000.

Depreciation was provided on the machine at 10 % on the original cost annually. In 1991, however, the company changed the method of depreciation and adopted the written down value method, rate of depreciation being 15 % p.a. Give the machine Account for four years from 1990 to 1993 assuming Accounting year ends on 31st December every year.

Ans: [Loss on sale of machine Rs. 305 and Rs. 5272
Machine Account Balance on 31.12.1993 Rs. 19656]

9. A lease is purchased on 1st Jan. 1990 for four years at a cost of Rs. 20,000. It is proposed to depreciate the lease by the annuity method charging 5 % interest. Show the Lease Account for four years and also the relevant entries in the Profit & Loss A/c.

Annuity Table shows that to depreciate Re. 1/- by annuity method over four years, charging interest @ 5 % one must write off a sum of Rs. 0.282012.

10. On 1st Jan., 1990, a lease was purchased for Rs. 20,000. It is to be replaced at the end of four years. It is expected that the investment will yield a net interest of 4 % per annum. A depreciation fund is established to collect the necessary sum of money.

On 31st Dec., 1993 the firm had a balance of Rs. 9100. The Depreciation Fund Investment realized Rs. 14700. The new lease cost Rs. 21500.

Sinking Fund Table shows that to get Re. 1 at the end of four years @ 4 % p.a. an annual investment of Rs. 0235490 is necessary.

Pass the necessary journal entries and prepare the necessary ledger Accounts for four years.

11. A firm starts in 1992. The crates bought and their estimated value in different years is given below:

	1992	1993	1994
Crates bought (Rs.)	16000	6400	11800
Estimated value on 31st Dec.	10800	10600	14000

Prepare Crates Accounts from 1992 to 1994.

Ans: [Depreciation for 1992 Rs. 5200, for 1993 Rs. 6600, for 1994 Rs. 8400]

12. A firm acquired a mine at a cost of Rs. 20,00,000 on 1st July, 1992. It was expected it would yield 200,000 tons of minerals in all. The actual output was 1992 – 10,000 tons, 1993 – 40,000 tons and 1994 – 32000 tons. Write up the Mine Account for the above years using depletion method of charging depreciation.

Ans: [Balance on 31.12.1994 Rs. 11,80,000]

13. A firm desires to debit Its profit & loss account with a uniform figure every year In respect of repairs & renewals. It expects that considering the life of the asset In question Rs. 10,000 will be the average amount to be spent every year. Actual repairs are Rs. 1000 In the first year, Rs. 2300 In the second year and Rs. 3700 In the third year, show the provision for Repairs & Renewals Account.

Ans: [Balance at the end of 3rd year Rs. 23,000]

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